Attachment 1

Internal Revenue Code, § 265. Expenses And Interest Relating To Tax-Exempt Income

265(b)(3)
Exception For Certain Tax-Exempt Obligations

265(b)(3)(A)
In General — Any qualified tax-exempt obligation acquired after August 7, 1986, shall be treated for purposes of paragraph (2) and section **291(e)(1)(B)** as if it were acquired on August 7, 1986.

265(b)(3)(B)
Qualified Tax-Exempt Obligation

265(b)(3)(B)(i)
In General — For purposes of subparagraph (A), the term "qualified tax-exempt obligation" means a tax-exempt obligation—

265(b)(3)(B)(i)(I) — which is issued after August 7, 1986, by a qualified small issuer,

265(b)(3)(B)(i)(II) — which is not a private activity bond (as defined in section **141**), and

265(b)(3)(B)(i)(III) — which is designated by the issuer for purposes of this paragraph.

265(b)(3)(B)(ii)
Certain Bonds Not Treated As Private Activity Bonds — For purposes of clause (i)(II), there shall not be treated as a private activity bond—

265(b)(3)(B)(ii)(I) — any qualified **501(c)(3)** bond (as defined in section **145**), or

265(b)(3)(B)(ii)(II) — any obligation issued to refund (or which is part of a series of obligations issued to refund) an obligation issued before August 8, 1986, which was not an industrial development bond (as defined in section **103(b)(2)** as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) or a private loan bond (as defined in section **103(o)(2)(A)**, as so in effect, but without regard to any exemption from such definition other than section **103(o)(2)(A)**).

265(b)(3)(C)
Qualified Small Issuer

265(b)(3)(C)(i)
In General — For purposes of subparagraph (B), the term "qualified small issuer" means, with respect to

obligations issued during any calendar year, any issuer if the reasonably anticipated amount of tax-exempt obligations (other than obligations described in clause (ii)) which will be issued by such issuer during such calendar year does not exceed $10,000,000.

265(b)(3)(C)(ii)
Obligations Not Taken Into Account In Determining Status As Qualified Small Issuer — For purposes of clause (i), an obligation is described in this clause if such obligation is—

265(b)(3)(C)(ii)(I) — a private activity bond (other than a qualified **501(c)(3)** bond, as defined in section **145**),

265(b)(3)(C)(ii)(II) — an obligation to which section **141(a)** does not apply by reason of section 1312, 1313, 1316(g), or 1317 of the Tax Reform Act of 1986 and which would (if issued on August 15, 1986) have been an industrial development bond (as defined in section **103(b)(2)** as in effect on the day before the date of the enactment of such Act) or a private loan bond (as defined in section **103(o)(2)(A)**, as so in effect, but without regard to any exception from such definition other than section **103(o)(2)(A)**), or

265(b)(3)(C)(ii)(III) — an obligation issued to refund (other than to advance refund within the meaning of section **149(d)(5)**) any obligation to the extent the amount of the refunding obligation does not exceed the outstanding amount of the refunded obligation.

265(b)(3)(C)(iii)
Allocation Of Amount Of Issue In Certain Cases — In the case of an issue under which more than 1 governmental entity receives benefits, if—

265(b)(3)(C)(iii)(I) — all governmental entities receiving benefits from such issue irrevocably agree (before the date of issuance of the issue) on an allocation of the amount of such issue for purposes of this subparagraph, and

265(b)(3)(C)(iii)(II) — such allocation bears a reasonable relationship to the respective benefits received by such entities, then the amount of such issue so allocated to an entity (and only such amount with respect to such issue) shall be taken into account under clause (i) with respect to such entity.

265(b)(3)(D)
Limitation On Amount Of Obligations Which May Be Designated

265(b)(3)(D)(i)
In General — Not more than $10,000,000 of obligations issued by an issuer during any calendar year may be designated by such issuer for purposes of this paragraph.

265(b)(3)(D)(ii)
Certain Refundings Of Designated Obligations Deemed Designated — Except as provided in clause (iii), in the case of a refunding (or series of refundings) of a qualified tax-exempt obligation, the refunding obligation shall be treated as a qualified tax-exempt obligation (and shall not be taken into account under clause (i)) if—

265(b)(3)(D)(ii)(I) — the refunding obligation was not taken into account under subparagraph (C) by reason of clause (ii)(III) thereof,

265(b)(3)(D)(ii)(II) — the average maturity date of the refunding obligations issued as part of the issue of which such refunding obligation is a part is not later than the average maturity date of the obligations to be refunded by such issue, and

265(b)(3)(D)(ii)(III) — the refunding obligation has a maturity date which is not later than the date which is 30 years after the date the original qualified tax-exempt obligation was issued.

Subclause (II) shall not apply if the average maturity of the issue of which the original qualified tax-exempt obligation was a part (and of the issue of which the obligations to be refunded are a part) is 3 years or less. For purposes of this clause, average maturity shall be determined in accordance with section **147(b)(2)(A)**.

265(b)(3)(D)(iii)
Certain Obligations May Not Be Designated Or Deemed Designated — No obligation issued as part of an issue may be designated under this paragraph (or may be treated as designated under clause (ii)) if—

265(b)(3)(D)(iii)(I) — any obligation issued as part of such issue is issued to refund another obligation, and

265(b)(3)(D)(iii)(II) — the aggregate face amount of such issue exceeds $10,000,000.

265(b)(3)(E)
Aggregation Of Issuers — For purposes of subparagraphs (C) and (D)—

265(b)(3)(E)(i)
— an issuer and all entities which issue obligations on behalf of such issuer shall be treated as 1 issuer,

265(b)(3)(E)(ii)
— all obligations issued by a subordinate entity shall, for purposes of applying subparagraphs (C) and (D) to each other entity to which such entity is subordinate, be treated as issued by such other entity, and

265(b)(3)(E)(iii)
— an entity formed (or, to the extent provided by the Secretary, availed of) to avoid the purposes of subparagraph (C) or (D) and all entities benefiting thereby shall be treated as 1 issuer.

265(b)(3)(F)
Treatment Of Composite Issues — In the case of an obligation which is issued as part of a direct or indirect composite issue, such obligation shall not be treated as a qualified tax-exempt obligation unless—

265(b)(3)(F)(i)
— the requirements of this paragraph are met with respect to such composite issue (determined by treating such composite issue as a single issue), and

265(b)(3)(F)(ii)
— the requirements of this paragraph are met with respect to each separate lot of obligations which are part of the issue (determined by treating each such separate lot as a separate issue).

265(b)(3)(G)
Special Rules For Obligations Issued During 2009 And 2010

265(b)(3)(G)(i)
Increase In Limitation — In the case of obligations issued during 2009 or 2010, subparagraphs (C)(i), (D)(i), and (D)(iii)(II) shall each be applied by substituting "$30,000,000" for "$10,000,000".

265(b)(3)(G)(ii)
Qualified 501(c)(3) Bonds Treated As Issued By Exempt Organization — In the case of a qualified **501(c)(3)** bond (as defined in section **145**) issued during 2009 or 2010, this paragraph shall be applied by treating the 501(c)(3) organization for whose benefit such bond was issued as the issuer.

265(b)(3)(G)(iii)
Special Rule For Qualified Financings — In the case of a qualified financing issue issued during 2009 or 2010—

265(b)(3)(G)(iii)(I) — subparagraph (F) shall not apply, and

265(b)(3)(G)(iii)(II) — any obligation issued as a part of such issue shall be treated as a qualified tax-exempt obligation if the requirements of this paragraph are met with respect to each qualified portion of the issue (determined by treating each qualified portion as a separate issue which is issued by the qualified borrower with respect to which such portion relates).

265(b)(3)(G)(iv)
Qualified Financing Issue — For purposes of this subparagraph, the term "qualified financing issue" means any composite, pooled, or other conduit financing issue the proceeds of which are used directly or indirectly to make or finance loans to 1 or more ultimate borrowers each of whom is a qualified borrower.

265(b)(3)(G)(v)
Qualified Portion — For purposes of this subparagraph, the term "qualified portion" means that portion of the proceeds which are used with respect to each qualified borrower under the issue.

265(b)(3)(G)(vi)
Qualified Borrower — For purposes of this subparagraph, the term "qualified borrower" means a borrower which is a State or political subdivision thereof or an organization described in section **501(c)(3)** and exempt from taxation under section **501(a)**.

265(b)(4)
Definitions — For purposes of this subsection—

265(b)(4)(A)
Interest Expense — The term "interest expense" means the aggregate amount allowable to the taxpayer as a deduction for interest for the taxable year (determined without regard to this subsection, section **264**, and section **291**). For purposes of the preceding sentence, the term "interest" includes amounts (whether or not designated as interest) paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares.

265(b)(4)(B)
Tax-Exempt Obligation — The term "tax-exempt obligation" means any obligation the interest on which is wholly exempt from taxes imposed by this subtitle. Such term includes shares of stock of a regulated investment company which during the taxable year of the holder thereof distributes exempt-interest dividends.

265(b)(5)
Financial Institution — For purposes of this subsection, the term "financial institution" means any person who—

265(b)(5)(A)
— accepts deposits from the public in the ordinary course of such person's trade or business, and is subject to Federal or State supervision as a financial institution, or

265(b)(5)(B)
— is a corporation described in section **585(a)(2)**.

265(b)(6)
Special Rules

265(b)(6)(A)
Coordination With Subsection (a) — If interest on any indebtedness is disallowed under subsection (a) with respect to any tax-exempt obligation—

265(b)(6)(A)(i)
— such disallowed interest shall not be taken into account for purposes of applying this subsection, and

265(b)(6)(A)(ii)
— for purposes of applying paragraph (2), the adjusted basis of such tax-exempt obligation shall be reduced (but not below zero) by the amount of such indebtedness.

265(b)(6)(B)
Coordination With Section 263A — This section shall be applied before the application of section **263A** (relating to capitalization of certain expenses where taxpayer produces property).

265(b)(7)
De Minimis Exception For Bonds Issued During 2009 Or 2010

265(b)(7)(A)
In General — In applying paragraph (2)(A), there shall not be taken into account tax-exempt obligations issued during 2009 or 2010.

265(b)(7)(B)
Limitation — The amount of tax-exempt obligations not taken into account by reason of subparagraph (A) shall not exceed 2 percent of the amount determined under paragraph (2)(B).

265(b)(7)(C)
Refundings — For purposes of this paragraph, a refunding bond (whether a current or advance refunding) shall be treated as issued on the date of the issuance of the refunded bond (or in the case of a series of refundings, the original bond).

Attachment 2

Treasury Regulation § 1.148-1 Definitions And Elections.

DE MINIMIS AMOUNT means--

(1) In reference to original issue discount (as defined in section **1273(a)(1)**) or premium on an obligation--

(i) An amount that does not exceed 2 percent multiplied by the stated redemption price at maturity; plus

(ii) Any original issue premium that is attributable exclusively to reasonable underwriters' compensation; and

(2) In reference to market discount (as defined in section **1278(a)(2)(A)**) or premium on an obligation, an amount that does not exceed 2 percent multiplied by the stated redemption price at maturity.

Attachment 3

Treasury Regulation § 1.148-8 Small Issuer Exception To Rebate Requirement.

*This regulation was last amended by T.D. **9777, 81 FR 46582**-46599 (July 18, 2016).*

1.148-8(a)
Scope. — Under section **148(f)(4)(D)**, bonds issued to finance governmental activities of certain small issuers are treated as meeting the arbitrage rebate requirement of section **148(f)(2)** (the "small issuer exception"). This section provides guidance on the small issuer exception.

1.148-8(b)
General Taxing Powers. — The small issuer exception generally applies only to bonds issued by governmental units with general taxing powers. A governmental unit has general taxing powers if it has the power to impose taxes (or to cause another entity to impose taxes) of general applicability which, when collected, may be used for the general purposes of the issuer. The taxing power may be limited to a specific type of tax, provided that the applicability of the tax is not limited to a small number of persons. The governmental unit's exercise of its taxing power may be subject to procedural limitations, such as voter approval requirements, but may not be contingent on approval by another governmental unit. See, also, section 148(f)(4)(D)(iv).

1.148-8(c)
Size Limitation--

1.148-8(c)(1)
In General. — An issue (other than a refunding issue) qualifies for the small issuer exception only if the issuer reasonably expects, as of the issue date, that the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by it during that calendar year will not exceed $5,000,000; or the aggregate face amount of all tax-exempt bonds of the issuer (other than private activity bonds) actually issued during that calendar year does not exceed $5,000,000. For this purpose, if an issue has more than a de minimis amount of original issue discount or premium, aggregate face amount means the aggregate issue price of that issue (determined without regard to pre-issuance accrued interest).

1.148-8(c)(2)
Aggregation Rules. — The following aggregation rules apply for purposes of applying the $5,000,000 size limitation under paragraph (c)(1) of this section.

1.148-8(c)(2)(i)
On-Behalf-Of Issuers. — An issuer and all entities (other than political subdivisions) that issue bonds on behalf of that issuer are treated as one issuer.

1.148-8(c)(2)(ii)
Subordinate Entities--

1.148-8(c)(2)(ii)(A)
In General. — Except as otherwise provided in paragraph (d) of this section and section 148(f)(4)(D)(iv), all bonds issued by a subordinate entity are also treated as issued by each entity to which it is subordinate. An issuer is subordinate to another governmental entity if it is directly or indirectly controlled by the other entity within the meaning of section **1.150-1(e)**.

1.148-8(c)(2)(ii)(B)
Exception For Allocations Of Size Limitation. — If an entity properly makes an allocation of a portion of its $5,000,000 size limitation to a subordinate entity (including an on behalf of issuer) under section **148(f)(4)(D)(iv)**, the portion of bonds issued by the subordinate entity under the allocation is treated as issued only by the allocating entity and not by any other entity to which the issuing entity is subordinate. These allocations are irrevocable and must bear a reasonable relationship to the benefits received by the allocating unit from issues issued by the subordinate entity. The benefits to be considered include the manner in which --

1.148-8(c)(2)(ii)(B)(1) — Proceeds are to be distributed;

1.148-8(c)(2)(ii)(B)(2) — The debt service is to be paid;

1.148-8(c)(2)(ii)(B)(3) — The facility financed is to be owned;

1.148-8(c)(2)(ii)(B)(4) — The use or output of the facility is to be shared; and

1.148-8(c)(2)(ii)(B)(5) — Costs of operation and maintenance are to be shared.

1.148-8(c)(2)(iii)
Avoidance Of Size Limitation. — An entity formed or availed of to avoid the purposes of the $5,000,000 size limitation and all entities that would benefit from the avoidance are treated as one issuer. Situations in which an entity is formed or availed of to avoid the purposes of the $5,000,000 size limitation include those in which the issuer --

1.148-8(c)(2)(iii)(A)
— Issues bonds which, but for the $5,000,000 size limitation, would have been issued by another entity; and

1.148-8(c)(2)(iii)(B)
— Does not receive a substantial benefit from the project financed by the bonds.

1.148-8(c)(3)
Certain Refunding Bonds Not Taken Into Account. — In applying the $5,000,000 size limitation, there is not taken into account the portion of an issue that is a current refunding issue to the extent that the stated principal amount of the refunding bond does not exceed the portion of the outstanding stated principal amount of the refunded bond paid with proceeds of the refunding bond. For this purpose, principal amount means, in reference to a plain par bond, its stated principal amount plus accrued unpaid interest, and in reference to any other bond, its present value.

1.148-8(d)
Pooled Financings—Treatment Of Conduit Borrowers. — A loan to a conduit borrower in a pooled financing qualifies for the small issuer exception, regardless of the size of either the pooled financing or of any loan to other conduit borrowers, only if—

1.148-8(d)(1)
— The bonds of the pooled financing are not private activity bonds;

1.148-8(d)(2)
— None of the loans to conduit borrowers are private activity bonds; and

1.148-8(d)(3)
— The loan to the conduit borrower meets all the requirements of the small issuer exception.

1.148-8(e)
Refunding Issues--

1.148-8(e)(1)
In General. — Sections 148(f)(4)(D)(v) and (vi) provide restrictions on application of the small issuer exception to refunding issues.

1.148-8(e)(2)
Multipurpose Issues. — The multipurpose issue allocation rules of section **1.148-9(h)** apply for purposes of determining whether refunding bonds meet the requirements of section **148(f)(4)(D)(v)**.

[T.D. **8418**, **57 FR 20971**-21033, May 18, 1992; corrected by **57 FR 44974**-44989, Sept. 30, 1992; revised by T.D. **8476**, **58 FR 33510**-33553, June 18, 1993; as amended by T.D. **9777**, **81 FR 46582**–46599, July 18, 2016.]

Attachment 4

Internal Revenue Code, § 148. Arbitrage

148(f)
Required Rebate To The United States

148(f)(4)(D)
Exception For Governmental Units Issuing $5,000,000 Or Less Of Bonds

148(f)(4)(D)(i)
In General — An issue shall, for purposes of this subsection, be treated as meeting the requirements of paragraphs (2) and (3) if—

148(f)(4)(D)(i)(I) — the issue is issued by a governmental unit with general taxing powers,

148(f)(4)(D)(i)(II) — no bond which is part of such issue is a private activity bond,

148(f)(4)(D)(i)(III) — 95 percent or more of the net proceeds of such issue are to be used for local governmental activities of the issuer (or of a governmental unit the jurisdiction of which is entirely within the jurisdiction of the issuer), and

148(f)(4)(D)(i)(IV) — the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by such unit during the calendar year in which such issue is issued is not reasonably expected to exceed

$5,000,000.

148(f)(4)(D)(ii)
Aggregation Of Issuers — For purposes of subclause (IV) of clause (I)—

148(f)(4)(D)(ii)(I) — an issuer and all entities which issue bonds on behalf of such issuer shall be treated as 1 issuer,

148(f)(4)(D)(ii)(II) — all bonds issued by a subordinate entity shall, for purposes of applying such subclause to each other entity to which such entity is subordinate, be treated as issued by such other entity, and

148(f)(4)(D)(ii)(III) — an entity formed (or, to the extent provided by the Secretary, availed of) to avoid the purposes of such subclause (IV) and all other entities benefiting thereby shall be treated as 1 issuer.

148(f)(4)(D)(iii)
Certain Refunding Bonds Not Taken Into Account In Determining Small Issuer Status — There shall not be taken into account under subclause (IV) of clause (i) any bond issued to refund (other than to advance refund) any bond to the extent the amount of the refunding bond does not exceed the outstanding amount of the refunded bond.

148(f)(4)(D)(iv)
Certain Issues Issued By Subordinate Governmental Units, Etc., Exempt From Rebate Requirement — An issue issued by a subordinate entity of a governmental unit with general taxing powers shall be treated as described in clause (I)(I) if the aggregate face amount of such issue does not exceed the lesser of—

148(f)(4)(D)(iv)(I) — $5,000,000, or

148(f)(4)(D)(iv)(II) — the amount which, when added to the aggregate face amount of other issues issued by such entity, does not exceed the portion of the $5,000,000 limitation under clause (I)(IV) which such governmental unit allocates to such entity.

For purposes of the preceding sentence, an entity which issues bonds on behalf of a governmental unit with general taxing powers shall be treated as a subordinate entity of such unit. An allocation shall be taken into account under subclause (II) only if it is irrevocable and made before the issuance date of such issue and only to the extent that the limitation so allocated bears a reasonable relationship to the benefits received by such governmental unit from issues issued by such entity.

148(f)(4)(D)(v)
Determination Of Whether Refunding Bonds Eligible For Exception From Rebate Requirement — If any portion of an issue is issued to refund other bonds, such portion shall be treated as a separate issue which does not meet the requirements of paragraphs (2) and (3) by reason of this subparagraph unless—

148(f)(4)(D)(v)(I) — the aggregate face amount of such issue does not exceed $5,000,000,

148(f)(4)(D)(v)(II) — each refunded bond was issued as part of an issue which was treated as meeting the requirements of paragraphs (2) and (3) by reason of this subparagraph,

148(f)(4)(D)(v)(III) — the average maturity date of the refunding bonds issued as part of such issue is not later than the average maturity date of the bonds to be refunded by such issue, and

148(f)(4)(D)(v)(IV) — no refunding bond has a maturity date which is later than the date which is 30 years after the date the original bond was issued.

Subclause (III) shall not apply if the average maturity of the issue of which the original bond was a part (and of the issue of which the bonds to be refunded are a part) is 3 years or less. For purposes of this clause, average maturity shall be determined in accordance with section 147(b)(2)(A).

148(f)(4)(D)(vi)
Refundings Of Bonds Issued Under Law Prior To Tax Reform Act Of 1986 — If section 141(a) did not apply to any refunded bond, the issue of which such refunded bond was a part shall be treated as meeting the requirements of subclause (II) of clause (v) if—

148(f)(4)(D)(vi)(I) — such issue was issued by a governmental unit with general taxing powers,

148(f)(4)(D)(vi)(II) — no bond issued as part of such issue was an industrial development bond (as defined in section 103(b)(2), but without regard to subparagraph (B) of section 103(b)(3)) or a private loan bond (as defined in section 103(o)(2)(A), but without regard to any exception from such definition other than section 103(o)(2)(C)), and

148(f)(4)(D)(vi)(III) — the aggregate face amount of all tax-exempt bonds (other than bonds described in subclause (II)) issued by such unit during the calendar year in which such issue was issued did not exceed $5,000,000.

References in subclause **(II)** to section **103** shall be to such section as in effect on the day before the date of the enactment of the Tax Reform Act of 1986. Rules similar to the rules of clauses **(ii)** and **(iii)** shall apply for purposes of subclause **(III)**. For purposes of subclause **(II)** of clause **(i)**, bonds described in subclause **(II)** of this clause to which section **141(a)** does not apply shall not be treated as private activity bonds.

148(f)(4)(D)(vii)
Increase In Exception For Bonds Financing Public School Capital Expenditures — Each of the $5,000,000 amounts in the preceding provisions of this subparagraph shall be increased by the lesser of $10,000,000 or so much of the aggregate face amount of the bonds as are attributable to financing the construction (within the meaning of subparagraph **(C)(iv)**) of public school facilities.

Attachment 5

Treasury Regulation § 1.148-7 Spending Exceptions To The Rebate Requirement.

1.148-7(f)
Construction Issue--

1.148-7(f)(1)
Definition. — CONSTRUCTION ISSUE means any issue that is not a refunding issue if --

1.148-7(f)(1)(i)
— The issuer reasonably expects, as of the issue date, that at least 75 percent of the available construction proceeds of the issue will be allocated to construction expenditures (as defined in paragraph (g) of this section) for property owned by a governmental unit or a 501(c)(3) organization; and

1.148-7(f)(1)(ii)
— Any private activity bonds that are part of the issue are qualified 501(c)(3) bonds or private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization.

1.148-7(f)(2)
Use Of Actual Facts. — For the provisions of paragraphs (e) through (m) of this section that apply based on the issuer's reasonable expectations, an issuer may elect on or before the issue date to apply all of those provisions based on actual facts, except that this election does not apply for purposes of determining whether an issue is a construction issue under paragraph (f)(1) of this section if the 1 and 1/2 percent penalty election is made under paragraph (k) of this section.

1.148-7(f)(3)
Ownership Requirement--

1.148-7(f)(3)(i)
In General. — A governmental unit or 501(c)(3) organization is treated as the owner of property if it would be treated as the owner for Federal income tax purposes. For obligations issued on behalf of a State or local governmental unit, the entity that actually issues the bonds is treated as a governmental unit.

1.148-7(f)(3)(ii)
Safe Harbor For Leases And Management Contracts. — Property leased by a governmental unit or a 501(c)(3) organization is treated as owned by the governmental unit or 501(c)(3) organization if the lessee complies with the requirements of section **142(b)(1)(B)**. For a bond described in section **142(a)(6)**, the requirements of section **142(b)(1)(B)** apply as modified by section **146(h)(2)**.

1.148-7(g)
Construction Expenditures--

1.148-7(g)(1)
Definition. — Except as otherwise provided, CONSTRUCTION EXPENDITURES means capital expenditures (as defined in section **1.150-1**) that are allocable to the cost of real property or constructed personal property (as defined in paragraph (g)(3) of this section). Except as provided in paragraph (g)(2) of this section, construction expenditures do not include expenditures for acquisitions of interests in land or other existing real property.

1.148-7(g)(2)
Certain Acquisitions Under Turnkey Contracts Treated As Construction Expenditures. — Expenditures are not for the acquisition of an interest in existing real property other than land if the contract between the seller and the issuer requires the seller to build or install the property (e.g., a TURNKEY CONTRACT), but only to the extent that the property has not been built or installed at the time the parties enter into the contract.

1.148-7(g)(3)
Constructed Personal Property. — CONSTRUCTED PERSONAL PROPERTY means tangible personal property (or, if acquired

pursuant to a single acquisition contract, properties) or specially developed computer software if --

1.148-7(g)(3)(i)
— A substantial portion of the property or properties is completed more than 6 months after the earlier of the date construction or rehabilitation commenced and the date the issuer entered into an acquisition contract;

1.148-7(g)(3)(ii)
— Based on the reasonable expectations of the issuer, if any, or representations of the person constructing the property, with the exercise of due diligence, completion of construction or rehabilitation (and delivery to the issuer) could not have occurred within that 6-month period; and

1.148-7(g)(3)(iii)
— If the issuer itself builds or rehabilitates the property, not more than 75 percent of the capitalizable cost is attributable to property acquired by the issuer (e.g., components, raw materials, and other supplies).

1.148-7(g)(4)
Specially Developed Computer Software. — SPECIALLY DEVELOPED COMPUTER SOFTWARE means any programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs, provided that the software is specially developed and is functionally related and subordinate to real property or other constructed personal property.

1.148-7(g)(5)
Examples. — The operation of this paragraph (g) is illustrated by the following examples.

Example 1.

Purchase of construction materials.

City A issues bonds to finance a new office building. A uses proceeds of the bonds to purchase materials to be used in constructing the building, such as bricks, pipes, wires, lighting, carpeting, heating equipment, and similar materials. Expenditures by A for the construction materials are construction expenditures because those expenditures will be capitalizable to the cost of the building upon completion, even though they are not initially capitalizable to the cost of existing real property. This result would be the same if A hires a third-party to perform the construction, unless the office building is partially constructed at the time that A contracts to purchase the building.

Example 2.

Turnkey contract.

City B issues bonds to finance a new office building. B enters into a turnkey contract with developer D under which D agrees to provide B with a completed building on a specified completion date on land currently owned by D. Under the agreement, D holds title to the land and building and assumes any risk of loss until the completion date, at which time title to the land and the building will be transferred to B. No construction has been performed by the date that B and D enter into the agreement. All payments by B to D for construction of the building are construction expenditures because all the payments are properly capitalized to the cost of the building, but payments by B to D allocable to the acquisition of the land are not construction expenditures.

Example 3.

Right-of-way.

P, a public agency, issues bonds to finance the acquisition of a right-of-way and the construction of sewage lines through numerous parcels of land. The right-of-way is acquired primarily through P's exercise of its powers of eminent domain. As of the issue date, P reasonably expects that it will take approximately 2 years to acquire the entire right-of-way because of the time normally required for condemnation proceedings. No expenditures for the acquisition of the right-of-way are construction expenditures because they are costs incurred to acquire an interest in existing real property.

Example 4.

Subway cars.

City C issues bonds to finance new subway cars. C reasonably expects that it will take more than 6 months for the subway cars to be constructed to C's specifications. The subway cars are constructed personal property. Alternatively, if the builder of the subway cars informs C that it will only take 3 months to build the subway cars to C's specifications, no payments for the subway cars are construction expenditures.

Example 5.

Fractional interest in property.

U, a public agency, issues bonds to finance an undivided fractional interest in a newly constructed power-generating facility. U contributes its ratable share of the cost of building the new facility to the project manager for the facility. U's contributions

are construction expenditures in the same proportion that the total expenditures for the facility qualify as construction expenditures.

Example 6.

Park land.

City D issues bonds to finance the purchase of unimproved land and the cost of subsequent improvements to the land, such as grading and landscaping, necessary to transform it into a park. The costs of the improvements are properly capitalizable to the cost of the land, and therefore, are construction expenditures, but expenditures for the acquisition of the land are not.

Attachment 6

Internal Revenue Code, § 144. Qualified Small Issue Bond; Qualified Student Loan Bond; Qualified Redevelopment Bond

144(a)
Qualified Small Issue Bond

144(a)(1)
In General — For purposes of this part, 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—

144(a)(1)(A)
— for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation, or

144(a)(1)(B)
— to redeem part or all of a prior issue which was issued for purposes described in subparagraph (A) or this subparagraph.

144(a)(2)
Certain Prior Issues Taken Into Account — If—

144(a)(2)(A)
— the proceeds of 2 or more issues of bonds (whether or not the issuer of each such issue is the same) are or will be used primarily with respect to facilities located in the same incorporated municipality or located in the same county (but not in any incorporated municipality),

144(a)(2)(B)
— the principal user of such facilities is or will be the same person or 2 or more related persons, and

144(a)(2)(C)
— but for this paragraph, paragraph **(1)** (or the corresponding provision of prior law) would apply to each such issue, then, for purposes of paragraph **(1)**, in determining the aggregate face amount of any later issue there shall be taken into account the aggregate face amount of tax-exempt bonds issued under all prior such issues and outstanding at the time of such later issue (not including as outstanding any bond which is to be redeemed (other than in an advance refunding) from the net proceeds of the later issue).

144(a)(3)
Related Persons — For purposes of this subsection, a person is a related person to another person if—

144(a)(3)(A)
— the relationship between such persons would result in a disallowance of losses under section **267** or **707(b)**, or

144(a)(3)(B)
— such persons are members of the same controlled group of corporations (as defined in section **1563(a)**, except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears therein).

144(a)(4)
$10,000,000 Limit In Certain Cases

144(a)(4)(A)
In General — At the election of the issuer with respect to any issue, this subsection shall be applied—

144(a)(4)(A)(i)
— by substituting "$10,000,000" for "$1,000,000" in paragraph **(1)**, and

144(a)(4)(A)(ii)
— in determining the aggregate face amount of such issue, by taking into account not only the amount described in paragraph **(2)**, but also the aggregate amount of capital expenditures with respect to facilities described in subparagraph (B) paid or incurred during the 6-year period beginning 3 years before the date of such issue and ending 3 years after such date (and financed otherwise than out of the proceeds of outstanding tax-exempt issues to which paragraph **(1)** (or the corresponding provision of prior law) applied), as if the aggregate amount of such capital expenditures constituted the face amount of a prior outstanding issue described in paragraph **(2)**.

144(a)(4)(B)
Facilities Taken Into Account — For purposes of subparagraph **(A)(ii)**, the facilities described in this subparagraph are facilities—

144(a)(4)(B)(i)
— located in the same incorporated municipality or located in the same county (but not in any incorporated municipality), and

144(a)(4)(B)(ii)
— the principal user of which is or will be the same person or 2 or more related persons.

For purposes of clause **(i)**, the determination of whether or not facilities are located in the same governmental unit shall be made as of the date of issue of the issue in question.

144(a)(4)(C)
Certain Capital Expenditures Not Taken Into Account — For purposes of subparagraph **(A)(ii)**, any capital expenditure—

144(a)(4)(C)(i)
— to replace property destroyed or damaged by fire, storm, or other casualty, to the extent of the fair market value of the property replaced,

144(a)(4)(C)(ii)
— required by a change made after the date of issue of the issue in question in a Federal or State law or local ordinance of general application or required by a change made after such date in rules and regulations of general application issued under such a law or ordinance,

144(a)(4)(C)(iii)
— required by circumstances which could not be reasonably foreseen on such date of issue or arising out of a mistake of law or fact (but the aggregate amount of expenditures not taken into account under this clause with respect to any issue shall not exceed $1,000,000), or

144(a)(4)(C)(iv)
— described in clause **(i)** or **(ii)** of section **41(b)(2)(A)** for which a deduction was allowed under section **174(a)**, shall not be taken into account.

144(a)(4)(D)
Limitation On Loss Of Tax Exemption — In applying subparagraph **(A)(ii)** with respect to capital expenditures made after the date of any issue, no bond issued as a part of such issue shall cease to be treated as a qualified small issue bond by reason of any such expenditure for any period before the date on which such expenditure is paid or incurred.

144(a)(4)(E)
Certain Refinancing Issues — In the case of any issue described in paragraph **(1)(B)**, an election may be made under subparagraph **(A)** of this paragraph only if all of the prior issues being redeemed are issues to which paragraph **(1)** (or the corresponding provision of prior law) applied. In applying subparagraph **(A)(ii)** with respect to such a refinancing issue, capital expenditures shall be taken into account only for purposes of determining whether the prior issues being

redeemed qualified (and would have continued to qualify) under paragraph **(1)** (or the corresponding provision of prior law).

144(a)(4)(F)
Aggregate Amount Of Capital Expenditures Where There Is Urban Development Action Grant — In the case of any issue 95 percent or more of the net proceeds of which are to be used to provide facilities with respect to which an urban development action grant has been made under section 119 of the Housing and Community Development Act of 1974, capital expenditures of not to exceed $10,000,000 shall not be taken into account for purposes of applying subparagraph **(A)(ii)**. This subparagraph shall not apply to bonds issued after December 31, 2006.

144(a)(4)(G)
Additional Capital Expenditures Not Taken Into Account — With respect to bonds issued after December 31, 2006, in addition to any capital expenditure described in subparagraph (C), capital expenditures of not to exceed $10,000,000 shall not be taken into account for purposes of applying subparagraph **(A)(ii)**.

144(a)(5)
Issues For Residential Purposes — This subsection shall not apply to any bond issued as part of an issue 5 percent or more of the net proceeds of which are to be used directly or indirectly to provide residential real property for family units.

144(a)(6)
Limitations On Treatment Of Bonds As Part Of The Same Issue

144(a)(6)(A)
In General — For purposes of this subsection, separate lots of bonds which (but for this subparagraph) would be treated as part of the same issue shall be treated as separate issues unless the proceeds of such lots are to be used with respect to 2 or more facilities—

144(a)(6)(A)(i)
— which are located in more than 1 State, or

144(a)(6)(A)(ii)
— which have, or will have, as the same principal user the same person or related persons.

144(a)(6)(B)
Franchises — For purposes of subparagraph **(A)**, a person (other than a governmental unit) shall be considered a principal user of a facility if such person (or a group of related persons which includes such person)—

144(a)(6)(B)(i)
— guarantees, arranges, participates in, or assists with the issuance (or pays any portion of the cost of issuance) of any bond the proceeds of which are to be used to finance or refinance such facility, and

144(a)(6)(B)(ii)
— provides any property, or any franchise, trademark, or trade name (within the meaning of section **1253**), which is to be used in connection with such facility.

144(a)(7)
Subsection Not To Apply If Bonds Issued With Certain Other Tax-Exempt Bonds — This subsection shall not apply to any bond issued as part of an issue (other than an issue to which paragraph **(4)** applies) if the interest on any other bond which is part of such issue is excluded from gross income under any provision of law other than this subsection.

144(a)(8)
Restrictions On Financing Certain Facilities — This subsection shall not apply to an issue if—

144(a)(8)(A)
— more than 25 percent of the net proceeds of the issue are to be used to provide a facility the primary purpose of which is one of the following: retail food and beverage services, automobile sales or service, or the provision of recreation or entertainment; or

144(a)(8)(B)
— any portion of the proceeds of the issue is to be used to provide the following: any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skating), racquet sports facility (including any handball or racquetball court), hot tub facility, suntan facility, or racetrack.

144(a)(9)
Aggregation Of Issues With Respect To Single Project — For purposes of this subsection, 2 or more issues part or all of the net proceeds of which are to be used with respect to a single building, an enclosed shopping mall, or a strip of offices, stores, or warehouses using substantial common facilities shall be treated as 1 issue (and any person who is a principal user with respect to any of such issues shall be treated as a principal user with respect to the aggregated issue).

144(a)(10)
Aggregate Limit Per Taxpayer

144(a)(10)(A)
In General — This subsection shall not apply to any issue if the aggregate authorized face amount of such issue allocated to any test-period beneficiary (when increased by the outstanding tax-exempt facility-related bonds of such beneficiary) exceeds $40,000,000.

144(a)(10)(B)
Outstanding Tax-Exempt Facility-Related Bonds

144(a)(10)(B)(i)
In General — For purposes of applying subparagraph **(A)** with respect to any issue, the outstanding tax-exempt facility-related bonds of any person who is a test-period beneficiary with respect to such issue is the aggregate amount of tax-exempt bonds referred to in clause **(ii)**—

144(a)(10)(B)(i)(I) — which are allocated to such beneficiary, and

144(a)(10)(B)(i)(II) — which are outstanding at the time of such later issue (not including as outstanding any bond which is to be redeemed (other than in an advance refunding) from the net proceeds of the later issue).

144(a)(10)(B)(ii)
Bonds Taken Into Account — For purposes of clause (i), the bonds referred to in this clause are—

144(a)(10)(B)(ii)(I) — exempt facility bonds, qualified small issue bonds, and qualified redevelopment bonds, and

144(a)(10)(B)(ii)(II) — industrial development bonds (as defined in section **103(b)(2)**, as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) to which section **141(a)** does not apply.

144(a)(10)(C)
Allocation Of Face Amount Of Issue

144(a)(10)(C)(i)
In General — Except as otherwise provided in regulations, the portion of the face amount of an issue allocated to any test-period beneficiary of a facility financed by the proceeds of such issue (other than an owner of such facility) is an amount which bears the same relationship to the entire face amount of such issue as the portion of such facility used by such beneficiary bears to the entire facility.

144(a)(10)(C)(ii)
Owners — Except as otherwise provided in regulations, the portion of the face amount of an issue allocated to any test-period beneficiary who is an owner of a facility financed by the proceeds of such issue is an amount which bears the same relationship to the entire face amount of such issue as the portion of such facility owned by such beneficiary bears to the entire facility.

144(a)(10)(D)
Test-Period Beneficiary — For purposes of this paragraph, except as provided in regulations, the term "test-period beneficiary" means any person who is an owner or a principal user of facilities being financed by the issue at any time during the 3-year period beginning on the later of—

144(a)(10)(D)(i)
— the date such facilities were placed in service, or

144(a)(10)(D)(ii)
— the date of issue.

144(a)(10)(E)
Treatment Of Related Persons — For purposes of this paragraph, all persons who are related (within the meaning of paragraph **(3)**) to each other shall be treated as 1 person.

144(a)(11)
Limitation On Acquisition Of Depreciable Farm Property

144(a)(11)(A)
In General — This subsection shall not apply to any issue if more than $250,000 of the net proceeds of such issue are to be used to provide depreciable farm property with respect to which the principal user is or will be the same person or 2 or more related persons.

144(a)(11)(B)
Depreciable Farm Property — For purposes of this paragraph, the term "depreciable farm property" means property of a character subject to the allowance for depreciation which is to be used in a trade or business of farming.

144(a)(11)(C)
Prior Issues Taken Into Account — In determining the amount of proceeds of an issue to be used as described in

subparagraph **(A)**, there shall be taken into account the aggregate amount of each prior issue to which paragraph **(1)** (or the corresponding provisions of prior law) applied which were or will be so used.

144(a)(12)
Termination Dates

144(a)(12)(A)
In General — This subsection shall not apply to—

144(a)(12)(A)(i)
— any bond (other than a bond described in clause **(ii)**) issued after December 31, 1986, or

144(a)(12)(A)(ii)
— any bond (or series of bonds) issued to refund a bond issued on or before such date unless—

144(a)(12)(A)(ii)(I) — the average maturity date of the issue of which the refunding bond is a part is not later than the average maturity date of the bonds to be refunded by such issue,

144(a)(12)(A)(ii)(II) — the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, and

144(a)(12)(A)(ii)(III) — the net proceeds of the refunding bond are used to redeem the refunded bond not later than 90 days after the date of the issuance of the refunding bond.

For purposes of clause (ii)(I), average maturity shall be determined in accordance with section **147(b)(2)(A)**.

144(a)(12)(B)
Bonds Issued To Finance Manufacturing Facilities And Farm Property — Subparagraph **(A)** shall not apply to any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide—

144(a)(12)(B)(i)
— any manufacturing facility, or

144(a)(12)(B)(ii)
— any land or property in accordance with section **147(c)(2)**.

144(a)(12)(C)
Manufacturing Facility — For purposes of this paragraph—

144(a)(12)(C)(i)
In General — The term "manufacturing facility" means 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.

144(a)(12)(C)(ii)
Certain Facilities Included — Such term includes facilities which are directly related and ancillary to a manufacturing facility (determined without regard to this clause) if—

144(a)(12)(C)(ii)(I) — such facilities are located on the same site as the manufacturing facility, and

144(a)(12)(C)(ii)(II) — not more than 25 percent of the net proceeds of the issue are used to provide such facilities.

144(a)(12)(C)(iii)
Special Rules For Bonds Issued In 2009 And 2010 — In the case of any issue made after the date of enactment of this clause and before January 1, 2011, clause **(ii)** shall not apply and the net proceeds from a bond shall be considered to be used to provide a manufacturing facility if such proceeds are used to provide—

144(a)(12)(C)(iii)(I) — a facility which is used in the creation or production of intangible property which is described in section **197(d)(1)(C)(iii)**, or

144(a)(12)(C)(iii)(II) — a facility which is functionally related and subordinate to a manufacturing facility (determined without regard to this subclause) if such facility is located on the same site as the manufacturing facility.

Attachment 7

Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-6...

NOV. 10, 1988

House Report 100-795

(for H.R. 4333)

SUMMARY CONTENTS

J. Tax-Exempt Bonds

1. Clarification of definition of manufacturing for qualified small-issue bonds

(sec. 362 of the bill and sec. 144 of the Code)

Present Law

Interest on State and local government bonds generally is tax-exempt (Code sec. 103). Interest on private activity bonds issued by such governments is taxable unless a specific exemption is provided in the Code. One exemption provided is for qualified small-issue bonds. Qualified small-issue bonds may be issued for manufacturing facilities only; authority to issue these bonds is scheduled to expire after December 31, 1989.

A manufacturing facility is defined as a facility for the production of tangible personal property. The fact that a de minimis amount of the space in a manufacturing plant is devoted to offices directly related to the manufacturing process conducted in the plant may be disregarded. However, a separate office wing of a larger, mixed-use building is treated as a nonmanufacturing facility.

Reasons for Change

The committee understands that some issuers are uncertain about the scope of the definition of manufacturing facility. The committee wishes to clarify its original intent.

Explanation of Provision

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.

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.

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.

Effective Date

This provision applies to bonds (including refunding bonds) issued after the date of the bill's enactment.

Attachment 8

Internal Revenue Code, § 142. Exempt Facility Bond

142(b)
Special Exempt Facility Bond Rules — For purposes of subsection (a)—

142(b)(2)
Limitation On Office Space — An office shall not be treated as described in a paragraph of subsection (a) unless—

142(b)(2)(A)
— the office is located on the premises of a facility described in such a paragraph, and

142(b)(2)(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.

Attachment 9

Department of the Treasury
Internal Revenue Service
Field Service Advice Memorandum

FSA 200010018

IRC Sec. 144- Qualified Small Issue Bond; Qualified Student Loan Bond; Qualified Redevelopment Bond

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

WASHINGTON, D.C. 20224

December 2, 1999

OFFICE OF CHIEF COUNSEL

Number: 200010018

Release Date: 3/10/2000 CC:DOM:FS:FI&P

TL-N-4814-99

UILC: 144.01-10

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler

Assistant Chief Counsel CC:DOM:FS

SUBJECT: Definition of Manufacturing Facility

This Field Service Advice responds to your memorandum dated August 31, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Corporation =

City =

Issuer =

c =

d =

e =

f =

g =

Date 1 =

ISSUE

Whether a facility used for the growing of plants is engaged in manufacturing within the meaning of **I.R.C. § 144(a)(12)(C)**.

CONCLUSION

The operations of the facility, which appear to be agricultural in nature, do not meet the definition of manufacturing within the meaning of **I.R.C. § 144(a)(12)(C)**.

FACTS

Corporation is engaged in the business of growing garden plants for both the wholesale and retail market. Corporation holds a patent for a growing process that purportedly results in faster- growing and more durable plants than conventional growing methods.

Corporation's operations are conducted on a c acre facility ("the Facility") in City. The Facility produces approximately d plants annually. The patented growing process begins with the germination of plants in state-of-the-art greenhouses equipped with heated floors, robotic watering systems and retractable roofs. Seedlings are placed in bottomless pots which alters the growth process. After several weeks, the seedlings are transplanted to fields for approximately one year. At the correct time of the year, the plants are harvested. While some plants are sold after harvesting, many are transferred to cold storage facilities where they are kept in a dormant state until they are packaged and shipped to buyers. The dormant state permits nationwide delivery of plants regardless of the season.

On Date 1, Issuer issued e of revenue bonds (the "Bond"). The Bond proceeds were used to construct f acres of state-of-the-art greenhouses as described above and a g square foot cold storage building located at the Facility. The greenhouses and the cold storage facility are used in the growing process described above.

LAW AND ANALYSIS

Section 103(a) of the **Internal Revenue Code** provides that gross income does not include interest on a State or local bond. Section 103(b)(1) provides that section 103(a) does not apply to any private activity bond, unless it is a qualified bond. Section 141(e)(1)(D) provides 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. Under section 144(a)(4), the issuer may elect to increase the $1,000,000 limitation to $10,000,000 provided certain other requirements are also met. The proceeds, however, are still required to be used in the manner described in section 144(a)(1).

Section 144(a)(12) provides, in part, that section 144(a) does not apply to any bond issued after December 31, 1986, unless 95 percent or more of the net bond proceeds are used to provide any manufacturing facility or any land or property in accordance with section 147(c)(2) relating to first-time farmers.

The exception for first-time farmers may apply if the land financed is to be used for farming purposes and is acquired by an individual who is a first-time farmer, who will be the principal user of such land, and who „viii materially and substantially participate on the farm of which such land is a part in the operation of such farm. **I.R.C. § 147(c)(2)(B)**. For purposes of this section, "farm" has the meaning given such term by section 6420(c)(2). Section 6420(c)(2) defines farm to include "nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards."

By permitting either manufacturing facilities or specified farming activities, section 144(a)(12)(B) establishes a distinction between manufacturing and agriculture for purposes of the qualified small issue bond rules, in the instant case, it is apparently undisputed that the exception for first-time farmers does not apply. Rather, Issuer and Corporation contend that Corporation is engaged in a manufacturing activity within the meaning of section 144(a)(12)(C)

Section 144(a)(12)(C) states that the term "manufacturing facility" means 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). 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.

While Corporation's growing process may require a high degree of technology and automation, they do not appear to be manufacturing facilities. The property financed with the Bond proceeds include greenhouses and other structures that are used primarily for the raising of garden plants, an agricultural commodity. While these facilities appear to meet the definition of farming under section 6420, the Issuer and Corporation apparently concede the exception for first-time farmers under sections 144(a)(12)(B)(ii) and 147(c)(2) does not apply. Thus, based on the information provided, it does not appear that the Bond proceeds were used for a qualified purpose under section 144(a).

Attachment 10

Date: February 7, 2001

INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

CASE MIS No.: TAM-120074-00/CC:TEGE:EOEG:TEB

Third Party Contact: * * *

Director, Tax Exempt Bonds: * * *

Attention: * * *

Taxpayer's Name: * * *

Taxpayer's Address: * * *

Taxpayer's Identification No: * * *

Years Involved: * * *

Date of Conference: * * *

LEGEND:

Date 1 = * * *

Issuer = * * *

Company = * * *

a = * * *

b = * * *

c = * * *

d = * * *

ISSUE

[1] Whether specially equipped greenhouses and a cold storage building used for growing and storing plants are a manufacturing facility within the meaning of section 144(a)(12)(C) of the Internal Revenue Code?

CONCLUSION

[2] The greenhouses and cold storage building are used for farming purposes on a farm within the meaning of section 6420(c)(2), and they are not manufacturing facilities under section 144(a)(12)(C).

FACTS

[3] On Date 1, Issuer issued $a of revenue bonds ("Bonds") and loaned the proceeds to Company. Company used the Bond proceeds to construct the Facility, consisting of b acres of state-of-the-art greenhouses and a c square-foot cold storage building. The Facility is located on d acres of land (the "Land"). Company uses the Facility to produce garden plants using a process described below. The Company uses the Facility solely for the plants it grows on the Land.

[4] Company holds a patent for a growing process that results in faster-growing and more durable plants than conventional growing methods. Germination of the plants begins in greenhouses equipped with high-density halogen lighting, heated floors, and robotic arms delivering water and other nutrients. After the plants and root systems grow, the plants are transplanted into special containers that alter the growth process by concentrating nutrients in the crown and in some of the roots of the plants. The plants are then moved into other greenhouses that are equipped with retractable roofs, heated floors, and robotic watering systems.

[5] After several weeks, the plants are moved from the greenhouses to fields on the Land. The plants are kept in the fields until they begin going dormant at which time many of the plants are moved to the cold storage building. In the cold storage building, the plants are trimmed, graded, and chilled until they become dormant. Before shipping, the plants are repotted in biodegradable containers and moved from the cold storage building back to the greenhouses. In the greenhouses, the plants are placed on the heated floors for several weeks to promote root growth and to start the growing process. Then, immediately prior to shipping, the plants are returned to the cold storage building to produce a semi-dormant state to prevent the plants from growing during shipping.

[6] Company does not meet the requirements of section 147(c)(2)(B) for first-time farmers.

LAW AND ANALYSIS

[7] Section 103(a) provides that gross income does not include interest on a State or local bond. Section 103(b)(1) provides that section 103(a) does not apply to any private activity bond, unless it is a qualified bond. Section 141(e)(1)(D) provides, in part, that a qualified small issue bond is a qualified bond.

[8] 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. Under section 144(a)(4), the issuer may elect to increase the $1,000,000 limitation to $10,000,000 provided certain other requirements are also met. The proceeds, however, are still required to be used in the manner described in section 144(a)(1).

[9] Section 144(a)(12) provides, in part, that section 144(a) does not apply to any bond issued after December 31, 1986, unless 95 percent or more of the net bond proceeds are to be used to provide any manufacturing facility or any land or property in accordance with section 147(c)(2). Section 144(a)(12)(C) states that the term "manufacturing facility" means 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).

[10] Section 147(c)(2) provides an exception to the limits on using bond proceeds to acquire land, and to the limits on using bond proceeds to acquire used property. For section 147(c)(2) to apply the land must be 1) used for farming purposes and 2) acquired by an individual who is a first-time farmer, who will be the principal user of such land, and who will materially and substantially participate on the farm of which such land is a part in the operation of the farm. If these requirements are met, the limitation on acquiring used property does not apply to property to be used on that land for farming purposes (subject to a dollar limitation). Section 147(c)(2)(D) provides that "farm" has the meaning given such term by section 6420(c)(2). Section 147 does not define the phrase "farming purposes."

[11] Section 6420, in part, describes when gasoline is used on a farm for purposes of an income tax credit. Section 6420(c)(2) provides that farm includes stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards. Section 48.6420-4(c) of the Manufacturers and Retailers Excise Tax Regulations provides that farm is used in its ordinary and accepted sense and generally means land used for the production of crops, fruits, or other agricultural products. Greenhouses and similar structures that are used primarily for purposes other than the raising of agricultural or horticultural commodities do not constitutes farms. For example, structures used primarily for the display, storage, fabrication or sale of wreaths, corsages and bouquets are not farms.

[12] Section 6420(c) also describes when gasoline is used for farming purposes. Section 48.6420-4(d) and (e)(1) provides, in part, that gasoline is used for farming purposes if it used by certain persons 1) on a farm in connection with cultivating the soil, raising or harvesting any agricultural or horticultural commodity, or 2) in handling, drying, packing, grading, or storing any agricultural or horticultural commodity in its unmanufactured state, but only if those persons produced more than one-half of the commodity which was so treated during the relevant period.

[13] Section 48.6420-4(e)(2) provides that gasoline is not used for farming purposes when it is used in connection with canning, freezing, packaging, or processing operations. For example, although gasoline used on a farm in connection with the production or harvesting of maple sap or oleoresin from a living tree is considered to be used for farming purposes, gasoline used in the processing of maple sap into maple syrup or used in the processing of oleoresin into gum spirits of turpentine is not used for farming purposes, even though these processing operations are conducted on a farm.

[14] The Facility is a farm. Section 6420(c)(2) specifically defines farm to include greenhouses and similar structures used primarily for the raising of horticultural commodities. Both the greenhouses and the cold storage building are primarily used for raising horticultural products.

[15] Further, the greenhouses and the cold storage building are used for farming purposes. Section 147 does not define farming purposes. Nevertheless, because section 147(c)(2) looks to section 6420 for the definition of "farm," it is reasonable to look to section 6420(c) to help define "farming purposes" for section 147(c)(2). The greenhouses are used for farming purposes because they are used to germinate and raise the plants. The activities in the cold storage building, which is used to put plants in a dormant state and for storage, are more akin to drying, packing and grading or storing unmanufactured horticultural products than they are to canning, freezing, packaging or processing operations.

[16] In this case, however, the Facility is not in accordance with section 147(c)(2) because the first-time farmer requirements are not met. The issue then is whether the Facility can be a manufacturing facility. We conclude that it cannot be. Congress made a distinction between manufacturing facilities and land or property described in section 147(c)(2). For land and property used on a farm for farming purposes, Congress provided that they could be financed if the first-time farmer requirements of that section were met. It would be inconsistent with congressional intent to permit land or property used on a farm for farming purposes that does not meet the first-time farmer requirements to be financed as a manufacturing facility.

[17] The taxpayer argues that the process it uses in the Facility creates a better plant (a faster growing and more durable plant) and, thus, the Facility is a manufacturing facility. Section 6420 does not determine whether property is a farm or is used for farming purposes based on the quality of the commodity produced. Thus, the Facility cannot be financed as a manufacturing facility with qualified small issue bonds.

[18] A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Rebecca Harrigal

Attachment 11

Department of the Treasury
Internal Revenue Service
Revenue Ruling

REV. RUL. 79-248, 1979-2 C.B. 41

Industrial development bonds; exempt small issue; capital expenditure. A corporation purchased equipment that is ordinarily leased, sold it to an unrelated leasing company, and leased it back for use in its manufacturing plant, which had been financed with industrial development bonds. For purposes of the exempt small issue limitation, the cost of the equipment is a capital expenditure made on the date of purchase by the corporation.

26 CFR 1.103-10: Exemption for certain small issues of industrial development bonds.

(Also Section 61; **1.61-7.**)

ISSUES

Is the cost of equipment that a corporation purchased, sold, and leased back for use in its manufacturing plant a capital expenditure within the meaning of section **103(b)(6)(D)(ii)** of the **Internal Revenue Code** of 1954 for purposes of determining if the exempt small issue limitation of $5,000,000 has been exceeded?

Is the interest on bonds issued by a city to finance the corporation's manufacturing plant excludable from the gross incomes of bondholders under section **103(a)(1)** of the Code?

FACTS

On February 1, 1978, the city issued industrial development bonds in the face amount of $4,800,000 to finance the acquisition of a manufacturing plant and equipment located in the city for use by a corporation that was not an exempt person within the meaning of section **103(b)(3)** of the Code. Prior to the issuance of the bonds, the city elected to treat the bonds as a $5,000,000 exempt small issue under the provisions of section **103(b)(6)(D)**. No prior exempt small issues were outstanding at the time the bonds were issued. Neither the city nor the corporation had expended any funds with respect to the plant and equipment during the three years prior to the issuance of the bonds. The bonds are not arbitrage bonds within the meaning of section **103(c)**.

After the plant had been placed in operation, the corporation decided to increase production by using additional equipment. On December 1, 1978, the corporation used its own funds to purchase equipment for a total cost of $600,000. On December 15, 1978, before the equipment was installed or placed in service, the corporation sold the equipment to an unrelated company engaged in the business of leasing this type of equipment. The corporation then leased the equipment back from the leasing company and used it in the plant. The corporation was not acting as an agent for the leasing company when it purchased the equipment on December 1, 1978. This type of equipment is ordinarily leased in general business practice.

LAW AND ANALYSIS

Section **103(a)(1)** of the Code provides that gross income does not include interest on obligations of a state or political subdivision thereof.

Section **103(b)(1)** of the Code provides that, with certain exceptions, the interest on "industrial development bonds" is not excludable from gross income.

Section **103(b)(6)(D)** of the Code provides that, at the election of the issuer, section **103(b)(1)** shall not apply to obligations issued in an aggregate face amount of $10,000,000 or less ($5,000,000 or less prior to January 1, 1979) and substantially all of the proceeds of which are to be used for the acquisition or construction of land or property of a character subject to the allowance for depreciation. For purposes of determining the aggregate face amount of such bond issue, there must be taken into account the face amount of the bonds to be issued, the outstanding face amount of any prior exempt small issues, and the aggregate amount of capital expenditures with respect to certain facilities.

Section **1.103-10(b)(2)(ii)** of the Income Tax Regulations provides that an expenditure is a section **103(c)(6)(D)** (redesignated as section **103(b)(6)(D)**) capital expenditure if:

(a) The capital expenditure was financed other than out of the proceeds of issues taken into account.

(b) The capital expenditures were paid or incurred during the 6-year period that begins 3 years before the date of issuance of the issue in question and ends 3 years after such date.

(c) The principal user of the facility in connection with which the property resulting from the capital expenditures is used and the principal user of the facility financed by the proceeds of the issue in question is the same person or are two or more related persons.

(d) Both facilities referred to in (c) were located in the same incorporated municipality or in the same county (outside of the incorporated municipalities in such county), and (e) The capital expenditures were properly chargeable to the capital account of any person or state or local governmental unit (whether or not such person is the principal user of the facility or a related person).

Section **1.103-10(b)(2)(iv)(b)** of the regulations provides that an expenditure is not a section **103(c)(6)(D)** (redesignated as section **103(b)(6)(D)**) capital expenditure if it is made by a person other than the user, a related person, or a state or local governmental unit and if it is made with respect to tangible personal property leased to the user of a facility. However, this provision applies only if the personal property is leased by its manufacturer or by a person in the trade or business of leasing that type or similar property, and only if property of that type is ordinarily leased in general business practice.

Section **1.103-10(b)(2)(i)(b)** of the regulations provides that the loss of the tax-exempt status of interest on obligations begins with the date on which the capital expenditure that caused the issue to cease to qualify under the $5,000,000 limit was paid or incurred.

Rev. Rul. **75-208**, 1975-1 C.B. 46, holds that the purchase of mobile buildings for temporary use during construction of a new building financed by an exempt small issue of industrial development bonds must be treated as a capital expenditure within the meaning of section **103(b)(6)(D)** of the Code. The amount of the capital expenditures may not be reduced by the amount received from the subsequent sale of the mobile buildings.

In this case, the corporation purchased the equipment for use in its plant located in the city and, in fact, the equipment was used by the corporation as lessee. The cost of the equipment was chargeable to the capital account of the corporation. Also, the subsequent purchase of the equipment by the leasing company was an expenditure chargeable to the capital account of the leasing company. Thus, on December 1, 1978, the purchase of the equipment by the corporation was a capital expenditure. In addition, the purchase of the equipment by the leasing company was a capital expenditure. However, for purposes of section **103(b)(6)(D)** of the Code, the capital expenditure made by the leasing company is not considered. See section **1.103-10(b)(2)(iv)(b)** of the regulations.

The sale of the equipment by the corporation did not reduce the amount of its original expenditure. See Rev. Rul. **75-208**. In addition, the original expenditure by the corporation was not an excluded expenditure for leased equipment as provided under section **1.103-10(b)(2)(iv)(b)** of the regulations.

HOLDING

The purchase of the equipment by the corporation was a capital expenditure within the meaning of section **103(b)(6)(D)(ii)** of the Code and section **1.103-10(b)(2)(ii)** of the regulations. The $5,000,000 exempt small issue limitation under section **103(b)(6)(D)** was exceeded on December 1, 1978, because the face amount of the bonds ($4,800,000) and the capital expenditures ($600,000) exceeded $5,000,000. Therefore, the exception provisions of section **103(b)(6)(D)** do not apply and the interest on the bonds is not excludable from the gross incomes of bond holders under section **103(a)(1)** beginning on December 1, 1978.

Attachment 12

Department of the Treasury
Internal Revenue Service
Revenue Ruling

REV. RUL. 80-162, 1980-1 C.B. 26

Industrial development bonds; exempt small issue; capital expenditures; leased equipment.

A corporation cancelled an order to purchase equipment when it discovered that the purchase would cause the exempt small issue limitation of section **103(b)(6)(D)** of the Code to be exceeded. Prior to cancellation, the corporation entered into an agreement with an unrelated corporation whereby the other corporation would purchase the equipment from the same vendors and lease it to the first corporation. The downpayments and deposits on the purchase, which were later refunded, are not capital expenditures. Rev. Rul. **79-248** distinguished.

26 CFR 1.103-10: Exemption for certain small issues of industrial development bonds.

(Also Section 61; **1.61-7.**)

ISSUE

Are certain downpayments and deposits on the purchase of equipment that were later refunded considered "capital expenditures" within the meaning of section **103(b)(6)(D)(ii)** of the **Internal Revenue Code** for purposes of determining if the exempt small issue limitation of $10,000,000 has been exceeded?

FACTS

In January 1979, City M issued industrial development bonds as defined in section **103(b)(2)** of the Code in the amount of $9,500,000. Substantially all of the bond proceeds were used to acquire an existing manufacturing facility located within M. The facility was leased to corporation X, a nonexempt person, for use in X's manufacturing operation. Prior to the issuance of the bonds, M made an election to have the bonds treated as a $10,000,000 exempt small issue under section **103(b)(6)(D)**. Neither M nor X had made any capital expenditures with respect to the facilities during the three years before the date of the issuance of the bonds. Prior to the issuance of the bonds, X did not own, lease, or operate any facilities in M. The bonds are not arbitrage bonds as described in section **103(c)**, and it was determined that the interest on the bonds was excludable from the gross incomes of the bondholders under the provisions of section **103(a)(1)**.

X decided to expand its operations at the facilities located in M by purchasing additional equipment. In February 1980, X ordered custom-made equipment and paid $600,000 to vendors from its own funds as downpayments and deposits. X discovered that the purchase of the equipment would be treated as a capital expenditure within the meaning of section **103(b)(6)(D)(ii)** of the Code and would cause the aggregate face amount of the bonds to exceed the $10,000,000 limitation for exempt small issues. With the consent of the vendors, X immediately entered into an arrangement with corporation Y, an unrelated

person, under which Y will purchase the custom-made equipment ordered by X from the vendors. Pursuant to a valid lease agreement between X and Y, Y will install the equipment in X's facility and lease it to X. The vendors terminated their contracts with X and refunded the downpayments and deposits to X. Y is in the business of leasing custom-made manufacturing equipment. The equipment to be leased by X is the type that is ordinarily the subject of a lease.

HOLDING

The downpayments and deposits made by X are not capital expenditures by X within the meaning of section **103(b)(6)(D)(ii)** of the Code because X did not purchase, acquire, or take delivery of any of the equipment prior to the termination of the purchase contracts. The equipment purchased by Y is not treated as a capital expenditure attributable to X because section **1.103-10(b)(2)(iv)** of the Income Tax Regulations specifically excludes expenditures for leased tangible personal property under the circumstances described above. Therefore, M's bonds will not exceed the exempt small issue limitation under section **103(b)(6)(D)**, and the interest on the bonds will continue to be excludable from the gross incomes of the bondholders under the provisions of section **103(a)(1)**.

EFFECT ON OTHER REVENUE RULINGS

The facts in Rev. Rul. **79-248**, 1979-2 C.B. 41, are distinguishable from the facts in this revenue Ruling. In Rev. Rul. **79-248** the completed purchase of equipment by a corporation is held to be a capital expenditure even though the corporation sold the equipment before placing it in service, while in this revenue Ruling the corporation did not actually complete the purchase of the equipment.

Attachment 13

Treasury Regulation § 1.103-10 Exemption For Certain Small Issues Of Industrial Development Bonds.

*This regulation was last amended by T.D. **7840, 47 FR 46084** (Oct. 15, 1982).*

1.103-10(a)
In General. — Section 103(b)(6) applies to certain industrial development bond issues (referred to in this section as "exempt small issues") and bonds issued to refund certain issues (referred to in this section as "exempt small refunding issues"). If an issue is an exempt small issue or an exempt small refunding issue, then under the requirements of section **103(b)(6)** and this section the interest paid on the debt obligations is not includable in gross income, and the obligations are treated as obligations described in section **103(a)(1)** and § **1.103-1**, even though such obligations are industrial development bonds as defined in section **103(b)(2)** and § 1.103-7. However, interest on an obligation of such an issue is includable in gross income if the obligation is held by a substantial user of the financed facilities or a related person (as described in section **103(b)(7)** and § **1.103-11**). Section **103(b)(6)** only becomes applicable where the bond issue meets both the trade or business and the security interest tests so that the obligations are industrial development bonds within the meaning of section **103(b)(2)**. For bonds issued before January 1, 1979, in taxable years ending before such date, and for capital expenditures made before January 1, 1979, with respect to such bonds, paragraphs (b), (c), and (d) of this section shall be applied by substituting $5 million for $10 million.

1.103-10(b)
Small Issue Exemption--

1.103-10(b)(1)
$1 Million Or Less. — Section 103(b)(6)(A) provides that section **103(b)(1)** shall not apply to any debt obligation issued by a State or local governmental unit as part of an issue where--

1.103-10(b)(1)(i)
— The aggregate authorized face amount of such issue (determined by aggregating the outstanding face amount of any prior exempt small issues described in paragraph (d) of this section and the face amount of the issue of obligations in question) is $1 million or less; and

1.103-10(b)(1)(ii)
— Substantially all of the proceeds of such issue is to be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation under section **167**. Proceeds which are loaned to a borrower for use as working capital or to finance inventory are not used in the manner described in the preceding sentence. Whether substantially all of the proceeds of an issue of governmental obligations are used in such manner is determined consistently with the rules for exempt facilities in § 1.103-8(a)(1)(i). Any obligation which is an industrial development bond within the meaning of section **103(b)(2)** and which satisfies the $1 million small issue exemption requirements is an exempt small issue. See paragraph (c)(1) of this section for the treatment of refunding issues of $1 million or less.

1.103-10(b)(2)
$10 Million Or Less.

1.103-10(b)(2)(i)
— Under section **103(b)(6)(D)**, the issuing State or local governmental unit may elect to have an aggregate authorized

face amount of $10 million or less, in lieu of the $1 million exemption otherwise provided for in section 103(b)(6)(A), with respect to issues of obligations that are industrial development bonds (within the meaning of section **103(b)(2)**) issued after October 24, 1968. If the election is made in a timely manner, the bonds will be treated as obligations of a State or local governmental unit described in section **103(a)(1)** and § **1.103-1** if the sum of

1.103-10(b)(2)(i)(a)
— The aggregate face amount of the issue including the aggregate outstanding face amount of any prior $1 million or $10 million exempt small issues taken into account under section **103(b)(6)(B)** and paragraph (d) of this section, and

1.103-10(b)(2)(i)(b)
— The aggregate amount of "section **103(b)(6)(D)** capital expenditures" (within the meaning of paragraph (b)(2)(ii) of this section),

is $10 million or less. In the case of an issue of obligations that qualified for exemption under section **103(b)(6)(A)** and this paragraph, if a section **103(b)(6)(D)** capital expenditure made after the date of issue has the effect of making taxable the interest on the issue, under section **103(b)(6)(G)** the loss of tax exemption for the interest shall begin only with the date on which the expenditure that caused the issue to cease to qualify under the $10 million limit was paid or incurred. See paragraph (b)(2)(vi) of this section for the time and manner in which the issuer may elect the $10 million exemption. See section **103(b)(6)(H)** and paragraph (c)(2) of this section for the treatment of certain refinancing issues of $10 million of less.

1.103-10(b)(2)(ii)
— The term "section **103(b)(6)(D)** capital expenditure" is defined in this subdivision. Special rules for applying such definition in the case of certain expenditures paid or incurred by a State or local governmental unit are prescribed in subdivision (iii) of this subparagraph. Except as excluded by subdivision (iv) or (v) of this subparagraph, an expenditure (regardless of how paid, whether in cash, notes, or stock in a taxable or nontaxable transaction) is a section **103(b)(6)(D)** capital expenditure if

1.103-10(b)(2)(ii)(a)
— The capital expenditure was financed other than out of the proceeds of issues to the extent such issues are taken into account under paragraph (b)(2)(i)(a) of this section.

1.103-10(b)(2)(ii)(b)
— The capital expenditures were paid or incurred during the 6-year period which begins 3 years before the date of issuance of the issue in question and ends 3 years after such date,

1.103-10(b)(2)(ii)(c)
— The principal user of the facility in connection with which the property resulting from the capital expenditures is used and the principal user of the facility financed by the proceeds of the issue in question is the same person or are two or more related persons (as defined in section 103(b)(6)(C) and paragraph (e) of this section),

1.103-10(b)(2)(ii)(d)
— Both facilities referred to in (c) of this subdivision were (during the period described in (b) of this subdivision or a part thereof) located in the same incorporated municipality or in the same county outside of the incorporated municipalities in such county), and

1.103-10(b)(2)(ii)(e)
— The capital expenditures were properly chargeable to the capital account of any person or State or local governmental unit (whether or not such person is the principal user of the facility or a related person) determined, for this purpose, without regard to any rule of the Code which permits expenditures properly chargeable to capital account to be treated as current expenses. With respect to obligations issued on or after August 8, 1972, determinations under the preceding sentence shall be made by including any expenditure which may, under any rule or election under the Code, be treated as a capital expenditure (whether or not such expenditure is so treated). With respect to obligations issued on or after August 8, 1972, for purposes of this subparagraph, capital expenditures made with respect to a contiguous or integrated facility which is located on both sides of a border between two or more political jurisdictions are made with respect to a facility located in all such jurisdictions and, therefore, shall be treated as if they were made in each such political jurisdiction.

1.103-10(b)(2)(iii)
— Amounts properly chargeable to capital account under subdivision (ii)(e) of this subparagraph include capital expenditures made by a State or local governmental unit with respect to an exempt facility or an industrial park, within the 6-year period described in subdivision (ii)(b) of this subparagraph, out of the proceeds of bond issues to which section 103(b)(1) did not apply by reason of section **103(b)(4)** or (5) (relating to certain exempt activities and industrial parks). Thus, for example, the cost to the lessor of a leased plantsite financed out of the proceeds of an issue for an exempt air pollution control facility under section 103(b)(4)(F) and paragraph (g) of § **1.103-8** would constitute a section **103(b)(6)(D)** capital expenditure. However, in the case of an industrial park, only the land costs allocated on an area basis to the plantsite and the actual cost of any improvements made on the plantsite, or to be used principally in connection with the actual plantsite occupied by a principal user or a related person, shall be taken into account as capital expenditures. Where the actual amount of capital expenditures made with respect to a facility by a person

(including a State or local governmental unit) other than the user of such facility (or a related person) cannot be ascertained, the fair market value of the property with respect to which the capital expenditures were made, at the time of such capital expenditures, shall be deemed to be the amount of such capital expenditures. In the case of a transaction which is not in form a purchase but which is treated as a purchase for Federal income tax purposes, the purchase price for Federal income tax purposes shall constitute a capital expenditure.

1.103-10(b)(2)(iv)
— A section **103(b)(6)(D)** capital expenditure shall not include any "excluded expenditure" described in (a) through (e) of this subdivision (iv).

1.103-10(b)(2)(iv)(a)
— A capital expenditure is an excluded expenditure if either it is made by a public utility company which is not the principal user of the facility financed by the proceeds of the issue in question (or a related person) with respect to property of such company, or it is made by a State or local governmental unit with respect to property of such unit, and if in either case it meets all of the following three conditions: Such property of such company or unit (as the case may be) must be used to provide gas, water, sewage disposal services, electric energy, or telephone service. Such property must be installed in, or connected to, the facility but must not consist of property which is such an integral part of the facility that the cost of such property is ordinarily included as part of the acquisition, construction, or reconstruction cost of such facility. Such property must be of a type normally paid for by the user (or a related person) in the form of periodic fees based upon time or use.

1.103-10(b)(2)(iv)(b)
— A capital expenditure is an excluded expenditure if it is made by a person other than the user, a related person, or a State or local governmental unit and if it is made with respect to tangible personal property (within the meaning of paragraph (c) of § **1.48-1**), or intangible personal property, leased to the user (or a related person) of a facility. However, the preceding sentence shall apply only if such personal property is leased by the manufacturer of such tangible or intangible personal property, or by a person in the trade or business of leasing property the same as, or similar to, such personal property, and only if, pursuant to general business practice, property of such type is ordinarily the subject of a lease.

1.103-10(b)(2)(iv)(c)
— A capital expenditure is an excluded expenditure if it is made to replace property damaged or destroyed by fire, storm, or other casualty, to the extent that these expenditures do not exceed in dollar amount the fair market value (determined immediately before the casualty) of the property replaced.

1.103-10(b)(2)(iv)(d)
— A capital expenditure is an excluded expenditure if it is required by a change made after the date of issue in a Federal or State law, or a local ordinance which has general application, or if it is required by a change made after such date in rules and regulations of general application issued under such law or ordinance.

1.103-10(b)(2)(iv)(e)
— A capital expenditure is an excluded expenditure if it is required by or arises out of circumstances which could not reasonably be foreseen on the date of issue or which arise out of a mistake of law or fact. However, the aggregate dollar amount taken into account under this subdivision (e) with respect to any issue may not exceed $1 million. With respect to expenditures incurred prior to December 11, 1971, the dollar amount specified in the preceding sentence shall be $250,000.

1.103-10(b)(2)(v)

1.103-10(b)(2)(v)(a)
— If the assets of a corporation are acquired by another corporation in a transaction to which section **381(a)** (relating to carryovers in certain corporate acquisitions) applies, the exchange of consideration by the acquiring corporation for such assets is not a section **103(b)(6)(D)** capital expenditure by such acquiring corporation.

1.103-10(b)(2)(v)(b)
— However, if an exchange referred to in (a) of this subdivision occurs during the 6-year period beginning 3 years before the date of issuance of an issue of obligations and ending 3 years after such date, the transferor and transferee shall be treated as having been related persons for the portion of such 6-year period preceding the date of the exchange for purposes of determining whether section **103(b)(6)(D)** capital expenditures have been made. For purposes of this subdivision (b), the date of an exchange to which section **381** applies shall be the date of distribution or transfer within the meaning of paragraph (b) of § **1.381(b)-1**.

1.103-10(b)(2)(v)(c)
— If section **351(a)** applies to a transfer of property to a corporation solely in exchange for its stock or securities, the issuance of such stock or securities in such exchange is not a section **103(b)(6)(D)** capital expenditure by such corporation.

1.103-10(b)(2)(v)(d)
— However, if such a transfer referred to in (c) of this subdivision occurs during the 6-year period beginning 3 years before the date of issuance of an issue of obligations and ending 3 years after such date, and if, with respect to the

property transferred, expenditures made within such period would have been section **103(b)(6)(D)** capital expenditures if the transferor and transferee had been related persons for such period, then such expenditures shall be considered to be section **103(b)(6)(D)** capital expenditures made by the transferee. In addition, if a transferor and transferee are related persons immediately following such transfer, such transferor and transferee shall also be treated as having been related persons for the portion of such 6-year period preceding the date of such transfer.

1.103-10(b)(2)(v)(e)
— For purposes of this subdivision (v), the term "issue of obligations" means an issue being tested for purposes of qualifying or continuing to qualify under an election pursuant to section **103(b)(6)(D)** as to which an amount which would be a section **103(b)(6)(D)** capital expenditure solely by reason of (b) or (d) of this subdivision must be taken into account.

1.103-10(b)(2)(v)(f)
— If with respect to an issue of obligations an expenditure would not have been a section **103(b)(6)(D)** capital expenditure but for the application of (b) or (d) of this subdivision, and if such section **103(b)(6)(D)** capital expenditure has the effect of making taxable the interest on an issue of obligations which qualified for exemption under section **103(b)(6)(A)** and this paragraph, the loss of tax exemption for such interest shall begin not earlier than the date of such exchange or transfer referred to in this subdivision (v).

1.103-10(b)(2)(vi)
— The issuer may make the election provided by section **103(b)(6)(D)** and this paragraph (b)(2) (assuming that the bonds otherwise qualify under section 103(b)(6) by noting the election affirmatively at or before the time of issuance of the issue in question on its books or records with respect to the issue. The term "books or records" includes the bond resolution or other similar legislation for the issue in question as well as the bond transcript or other compilation of bond and bond-related documents. If the issuer fails to make an election at the time and in the manner prescribed in this paragraph (b)(2), the issue will not be treated as described in section **103(b)(6)(D)**, and interest thereon will be includible in gross income.

1.103-10(c)
Refunding Or Refinancing Issue Exemption--

1.103-10(c)(1)
$1 Million Or Less Refunding Issue. — Section 103(b)(6)(A) also provides that section **103(b)(1)** shall not apply to any debt obligation issued by a State or local governmental unit as part of an issue the aggregate authorized face amount of which is $1 million or less, if substantially all of the proceeds of such issue are to be used--

1.103-10(c)(1)(i)
— To redeem part of all of a prior issue substantially all of the proceeds of which were used to acquire, construct, reconstruct, or improve land or property of a character subject to the allowance for depreciation, or

1.103-10(c)(1)(ii)
— To redeem part or all of a prior exempt small refunding issue.

1.103-10(c)(2)
$10 Million Or Less Refinancing Issue. — Section 103(b)(6)(H) provides that section **103(b)(1)** shall not apply to any debt obligation issued by a governmental unit as part of an issue which is $10 million or less if the condition of section **103(b)(6)(H)** is met and if substantially all of the proceeds are to be used--

1.103-10(c)(2)(i)
— To redeem part or all of one or more prior exempt small issues, or

1.103-10(c)(2)(ii)
— To redeem part or all of one or more prior exempt small refunding issues.

The condition of section **103(b)(6)(H)** is that an election by the issuer of the $10 million exemption in lieu of the $1 million limit for a refunding issue may be made only if each prior issue being redeemed is an issue which qualified either for the $1 million exemption or, by reason of an election under section **103(b)(6)(D)**, for the $10 million exemption. In addition, in applying the capital expenditures test under section **103(b)(6)(D)(ii)** and paragraph (b)(2)(i)(b) of this section to refinancing issues, section **103(b)(6)(D)** capital expenditures are taken into account only for purposes of determining whether prior issues which were made under the section **103(b)(6)(D)** election qualified under section **103(b)(6)(A)** and would have continued to qualify under that section but for the redemption.

1.103-10(d)
Certain Prior Issues Taken Into Account--

1.103-10(d)(1)
In General. — Section 103(b)(6)(B) provides, in effect, that if (i) a prior issue specified in subparagraph (2) of this paragraph is an exempt small issue (including for this purpose an exempt small refunding issue) under section **103(b)(6)(A)** and this section, and (ii) such prior issue is outstanding at the time of issuance of a subsequent issue, then in determining the aggregate face amount of such subsequent issue (for purposes of determining whether such issue is a $1 million or $10

million exempt small issue under section 103(b)(6)(A) and this section) there shall be taken into account the outstanding face amount of such prior exempt small issue. For purposes of this paragraph, the outstanding face amount of a prior exempt small issue does not include the face amount of any obligation which is to be redeemed from the proceeds of such subsequent issue.

1.103-10(d)(2)
Prior Issues Specified. — The face amount of an outstanding prior exempt small issue is taken into account under subparagraph (1) of this paragraph if--

1.103-10(d)(2)(i)
— The proceeds of both the prior exempt small issue and of the subsequent issue (whether or not the State or local governmental unit issuing such obligation is the same unit for each such issue) are or will be used primarily with respect to facilities located or to be located in the same incorporated municipality or located or to be located in the same county outside of an incorporated municipality in such county (and, for purposes of this subdivision, on or after August 8, 1972, a contiguous or integrated facility which is located on both sides of a border between two or more political jurisdictions shall be treated as if it is entirely within each such political jurisdiction), and

1.103-10(d)(2)(ii)
— The principal user of the financed facilities referred to in subdivision (i) of this subparagraph is or will be the same person or two or more related persons (as defined in section **103(b)(6)(C)** and paragraph (e) of this section).

1.103-10(d)(3)
Rules Of Application. — The rules of this paragraph shall apply--

1.103-10(d)(3)(i)
— Only in the case of outstanding prior exempt small issues which are industrial development bonds to which section **103(b)(1)** would have applied but for the provisions of section **103(b)(6)**. Thus, for example, the provisions of this paragraph do not apply in respect of a prior issue of obligations issued on or before April 30, 1968. In addition, the provisions of this paragraph do not apply in respect of a prior issue for an exempt facility under section **103(b)(4)** and § **1.103-8**, or for an industrial park under section **103(b)(5)** and § **1.103-9**, whether or not the issue might also have qualified as an exempt small issue under section **103(b)(6)(A)** and this section.

1.103-10(d)(3)(ii)
— To all prior exempt small issues which meet the requirements of this paragraph. Thus, for example, in determining the aggregate face amount of an issue under section **103(b)(6)(A)**, the outstanding face amount of prior $1 million or $10 million exempt small issues which meet the requirements of this paragraph shall be taken into account in determining the aggregate face amount of a subsequent issue being tested for the $1 million small issue exemption. Similarly, in determining the aggregate face amount of an issue under section **103(b)(6)(A)** and (D), the outstanding face amount of prior $1 million or $10 million exempt small issues which meet the requirements of this paragraph shall be taken into account in determining the aggregate face amount of a subsequent issue being tested for the $10 million small issue exemption.

1.103-10(e)
Related Persons. — For purposes of section **103(b)** and §§ **1.103-7** through **1.103-11**, the term "related person" means a person who is related to another person if, on the date of issue of an issue of obligations--

1.103-10(e)(1)
— The relationship between such persons would result in a disallowance of losses under section **267** (relating to disallowance of losses, etc., between related taxpayers) and section **707(b)** (relating to losses disallowed, etc., between partners and controlled partnerships) and the regulations thereunder, or

1.103-10(e)(2)
— Such persons are members of the same controlled group of corporations, as defined in section **1563(a)**, relating to definition of controlled group of corporations (except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section **1563(a)**) and the regulations thereunder.

1.103-10(f)
Disqualification Of Certain Small Issues.

1.103-10(f)(1)
— Section 103(b)(6) shall not apply to any obligation issued after April 24, 1979, which is part of an issue, a significant portion of the proceeds of which are to be used directly or indirectly to provide residential real property for family units. For purposes of the preceding sentence, the term "residential real property for family units" means residential rental projects (within the meaning of § **1.103-8(b)**) and owner-occupied residences (within the meaning of section **103A**).

1.103-10(f)(2)
— For purposes of paragraph (f)(1), a significant portion of the proceeds of an issue are used to provide residential real property for family units if 5 percent or more of the proceeds are so used.

1.103-10(g)
Examples. — The application of the rules contained in section **103(b)(6)** and this section are illustrated by the following

examples:

Example (1)

County A and corporation X enter into an arrangement under which the county will provide a factory which X will lease for 25 years. The arrangement provides (1) that A will issue $1 million of bonds on March 1, 1970, (2) that the proceeds of the bond issue will be used to acquire land in County A (but not in an incorporated municipality) and to construct and equip a factory on such land in accordance with X's specifications, (3) that X will rent the facility for 25 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that such payments by X and the facility itself shall be the security for the bonds. Although the bonds issued are industrial development bonds, the bonds are an exempt small issue under section **103(b)(6)(A)** and this section since the aggregate authorized face amount of the bond issue is $1 million or less and all of the proceeds of the bond issue are to be used to acquire and improve land and acquire and construct depreciable property. The result would be the same if the arrangement provided that X would purchase the facility from A.

Example (2)

The facts are the same as in example (1) except that, instead of acquiring land and constructing a new factory, the arrangement provides that A will acquire a vacant existing factory building and rebuild and equip the building in accordance with X's specifications. The bonds are an exempt small issue for the same reasons as in example (1).

Example (3)

The facts are the same as in example (1) or (2) except that the financed facilities are additions to facilities which were financed by an issue of bonds to which section **103(b)(1)** does not apply because such bonds were issued prior to May 1, 1968, or were subject to the transitional provisions of § 1.103-12. The bonds are an exempt small issue since neither of the prior bond issues are taken into account under section **103(b)(6)(B)** and this section in determining the status of industrial development bonds which are issued after April 30, 1968, and which are not subject to the transitional provisions of § 1.103-12.

Example (4)

The facts are the same as in example (1) except that, subsequently, corporation X proposes to County A that A build a $400,000 warehouse located in Town M (an unincorporated town located in County A) for X under terms similar to the factory arrangement described in example (1). On the proposed issue date of the subsequent bond issue, $600,000 of the first exempt small issue will be outstanding. If A issues $400,000 of bonds for such purposes, the bonds will be an exempt small issue under section **103(b)(6)** and this section since, under the rules of section 103(b)(6)(B) and paragraph (d) of this section, if the aggregate authorized face amount of the new issue and the outstanding prior exempt small issue will be $1 million or less, the new issue will be an exempt small issue. If, however, the aggregate authorized face amount of the prior issue outstanding on the date of the subsequent issue were in excess of $600,000, the subsequent issue would not qualify as an exempt small issue because (1) the combined aggregate face amount of the outstanding prior issue and the new issue would be in excess of $1 million, (2) the facilities financed by both issues are to be located in unincorporated areas in the same county, (3) the same taxpayer will be the principal user of both facilities, and (4) but for the rules of section **103(b)(6)(B)** and paragraph (d) of this section the prior issue would be an exempt small issue.

Example (5)

The facts are the same as in example (1) except that subsequently corporation X proposes to City P and City R (incorporated municipalities located in County A) that P and R each issue bonds and each build $1 million facilities to be located in Cities P and R for the use of X under terms similar to the arrangement in example (1). Each of the $1 million issues will be an exempt small issue because each proposed facility is located within a different incorporated municipality and the proceeds of the prior outstanding exempt small issue were used to construct facilities outside of an incorporated area.

Example (6)

The facts are the same as in example (1) except that $95,000 of the $1 million will be used by the corporation as working capital. The bonds are an exempt small issue for the same reason as in example (1) since substantially all of the proceeds will be used for the acquisition of land and the construction of depreciable property.

Example (7)

The facts are the same as in example (1) except that on November 1, 1969, County A issued $10 million of industrial development bonds, all of the proceeds of which were issued for the acquisition of land as the site for an industrial park within the meaning of section 103(b)(5) and § **1.103-9**. The proceeds of the $1 million of bonds issued in 1970 will be used to construct a factory for corporation X to be located in the industrial park. The bonds issued in 1970 are industrial development bonds within the meaning of section **103(b)(2)** and § 1.103-7. Since, however, the prior 1969 issue is not an issue to which section **103(b)(6)(A)** applied (see paragraph (d)(3)(i) of this section), the bonds issued in 1970 are an exempt small issue for the reasons stated in example (1).

Example (8)

County B enters into three separate arrangements with three unrelated corporations whereby the county will provide separate storage facilities for each corporation. The arrangement provides (1) that the county will issue bonds and loan to each

corporation $250,000 of the proceeds which will be used to acquire land in the county and to construct the facilities, (2) that the rental payments by the corporations will be equal to the amount necessary to amortize the principal and pay the interest on any outstanding bonds issued by the county, and (3) that the payments by the corporations and the facilities themselves shall be the security for the industrial development bonds. For convenience, the county issues one series of bonds in the face amount of $750,000 rather than three separate series of bonds of $250,000 each. The issue is an exempt small issue under section **103(b)(6)(A)** and paragraph (b)(1) of this section since the aggregate authorized face amount of the bond issue is $1 million or less, and all of the proceeds of the bond issue are to be used to acquire and improve land and acquire and construct depreciable property.

Example (9)

City C and corporation Y enter into an arrangement under which C will provide a factory which Y will lease for 25 years. The arrangement provides (1) that C will issue $4 million of bonds on March 1, 1969, after making the election under section **103(b)(6)(D)** and paragraph (b)(2) of this section, (2) that the proceeds of the bond issue will be used to acquire land in the city and to construct and equip a factory on such land in accordance with Y's specifications, (3) that Y will rent the facilities for 25 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, (4) that such payments by Y and the facility itself shall be the security for the bonds, and (5) that, if corporation Y pays or incurs capital expenditures in excess of $1 million within 3 years from the date of issue which disqualify the bonds as an exempt small issue under section 103(b)(6)(D), it will either furnish funds to C to redeem such bonds at par or at a premium, or increase the rental payments to C in an amount sufficient to pay a premium interest rate. Although the bonds issued are industrial development bonds, they are an exempt small issue under section 103(b)(6)(A) by reason of the election under section **103(b)(6)(D)** and paragraph (b)(2) of this section, since the aggregate authorized face amount of the bond issue is $5 million or less and all of the proceeds of the bond issue are to be used to acquire and improve land and acquire and construct depreciable property. The provisions for redemption of the bonds or an increase in rental if the bonds are disqualified as an exempt small issue under section **103(b)(6)(A)** will not disqualify an otherwise valid election under section **103(b)(6)(D)** and paragraph (b)(2) of this section.

Example (10)

The facts are the same as in example (9) except that corporation Y subsequently proposed to the city that it build a $1 million warehouse next to the plant for the use of Y under terms similar to the factory arrangement. Assume further that the factory building was completed by March 1, 1970, and that on January 15, 1972, the proposed issue date of the subsequent bond issue, $2 million of the first exempt small issue will be outstanding. In determining the aggregate authorized face amount of the new issue, the original face amount of a prior outstanding issue must be reduced by that portion which is to be redeemed before it is added to the face amount of the new issue. Therefore, if the city issues $3 million of bonds to redeem the remaining $2 million of bonds and to construct the warehouse the bonds will be an exempt small issue under section **103(b)(6)(A)** if an election is made under section 103(b)(6)(D) and paragraph (b)(2) of this section since (1) the face amount of the new issue ($3 million), plus (2) the face amount of the prior outstanding exempt small issue minus the amount of such issue to be refunded ($2 million minus $2 million), plus (3) capital expenditures during the preceding 3 years financed other than out of the proceeds of outstanding issues to which section **103(b)(6)(A)** and paragraph (b) of this section applied ($2 million), do not exceed $5 million. If, however, the amount of the January 15, 1972, issue were $3 1/2 million, the issue would not qualify as an exempt small issue under section **103(b)(6)(A)** and paragraph (b)(2) of this section.

Example (11)

The facts are the same as in example (9), except that on June 15, 1971, Y purchases from an unrelated motor carrier business a warehouse terminal in the same city at a cost of $250,000 and tractor-trailers and other automotive equipment based at the terminal at a cost of $1 million. This subsequent expenditure by Y has the effect of making the interest on the city C bonds includable in the gross income of the holders of such bonds as of June 15, 1971, because the face amount of the March 1, 1969, issue ($4 million) plus the subsequent capital expenditures within 3 years of the date of issue ($1,250,000) exceed $5 million. (See section **103(b)(6)(D)** and paragraph (b)(2)(i) of this section.)

Example (12)

The facts are the same as in example (9), except that in March, 1970, Y will move $3 million of additional used machinery and equipment into the factory from its factory in another city. The expenditures for such machinery and equipment were incurred by Y more than 3 years prior to the date of issue of the bonds. The transfer of such used equipment into city C does not constitute a section **103(b)(6)(D)** capital expenditure within the meaning of paragraph (b)(2)(ii) of this section since the expenditures with respect to such property were incurred more than 3 years prior to the date of issue of the bonds. Had the capital expenditures with respect to such property been incurred during the 6-year period beginning 3 years before the date of issue of the bonds and in the 3 years after such date, they would constitute section **103(b)(6)(D)** capital expenditures.

Example (13)

The facts are the same as in example (9), except that in March 1970, corporation Y enters into an arrangement with respect to machinery and equipment to be used in the facility. The arrangement is labeled by the parties as a lease but is treated as a sale for Federal income tax purposes. The amount treated as the purchase price of the machinery and equipment is a section **103(b)(6)(D)** capital expenditure.

Example (14)

On February 1, 1970, city D issues $5 million of its bonds to finance construction of an addition to the manufacturing plant of corporation Z. The bonds will be secured by the facility and lease payments to be made by Z which will be sufficient to pay the principal and interest on such bonds. Assume that the bonds qualify as an exempt small issue under section **103(b)(6)(A)** pursuant to an election under section 103(b)(6)(D) and paragraph (b)(2) of this section. On February 1, 1971, D plans to issue $1 million of its bonds to construct a pollution control facility to be leased to Z for use at its manufacturing plant. The rental payments from the lease will be sufficient to pay the principal and interest on the bonds. The bonds will be secured by such facility and the lease payments. Capital expenditures for the pollution control facility will be paid or incurred beginning before February 1, 1973. Although the pollution control facility is an exempt facility under section 103(b)(4)(F) and paragraph (g) of § **1.103-8**, amounts used for the pollution control facility shall be considered to be a section 103(b)(6)(D) capital expenditure and the interest on the February 1, 1970, issue will become taxable as of the date such capital expenditure began to be paid or incurred. See section **103(b)(6)(G)** and paragraph (b)(2)(i) of this section.

Example (15)

On February 1, 1970, City E issues $500,000 of its bonds to acquire and develop an industrial park within the meaning of section 103(b)(5) and paragraph (b) of § **1.103-9**. The park consists of 100 acres and is divided into one 50 acre plantsite and 4 smaller sites. The aggregate acquisition cost of the undeveloped land is $150,000 or an average per acre cost of $1,500. Roads, sidewalks, sewers, utilities, sewage, and waste disposal facilities serving the entire industrial park cost $300,000. On September 1, 1970, E leases to corporation Y for 30 years the 50 acre plantsite (with an allocated cost of $75,000) and a railroad spur track from the railroad right of way to Y's plantsite for Y's exclusive use. The spur track was constructed using $50,000 of the proceeds of the industrial park bond issue. E also proposes to issue on September 1, 1970, $4,875,000 of its bonds to construct and equip a building on the leased plantsite to be leased to Y at an additional rental sufficient to pay the principal and interest on this issue of bonds. The September 1, 1970, issue will be an exempt small issue under section 103(b)(6)(A) pursuant to an election under section **103(b)(6)(D)** and paragraph (b)(2) of this section since the sum of the amount of the second issue ($4,875,000) and the capital expenditures allocated to the plantsite ($75,000 for 50 acres of land plus $50,000 for the railroad spur tract, totaling $125,000) does not exceed $5 million. The sum of $300,000 which was spent in development of the industrial park provided facilities which will serve or benefit the users generally and hence under paragraph (b)(2)(iii) of this section is not considered to have provided facilities as to which Y will be the principal user.

Example (16)

On June 1, 1970, corporation Z simultaneously enters into separate arrangements with City F and City G under which each city will issue a $5 million exempt small issue of bonds the proceeds of which will be used by Z to construct separate facilities in each city. By June 1, 1971, the facilities have been completed in the respective cities. On January 1, 1972, Cities F and G, through a valid legal proceeding, merge into a new City FG. Since in this case F and G were separate cities on June 1, 1970 (the date of the bond issues), the factories are not considered to be located in the same incorporated municipality. Accordingly, each $5 million issue by City F and G will continue to qualify as an exempt small issue.

Example (17)

On June 1, 1973, City H issues an exempt small issue of $4.75 million to finance a facility of corporation S to be located in City H. On October 1, 1974, S and corporation T, previously unrelated to S, consummated a statutory merger which qualifies as a reorganization described in section **368(a)(1)(A)** and thus as a transaction described in section **381(a)**. In the transaction, T transferred to S assets with a fair market value of $1.5 million in exchange for stock of S, $300,000 of securities of S, and $100,000 cash. On March 23, 1971, T made $400,000 of capital expenditures for an addition to its factory located in City H. For purposes of testing the H issue of June 1, 1973, such expenditures would have been section **103(b)(6)(D)** capital expenditures if T and S had been related persons. Under the provisions of paragraph (b)(2)(v)(a) of this section, the exchange of $1.5 million of stock, securities, and cash by S does not constitute a section **103(b)(6)(D)** capital expenditure. Since, however, S and T are treated as related persons starting 3 years prior to the date of issue of the obligations, the $400,000 of expenditures by T constitute section **103(b)(6)(D)** capital expenditures. Thus, the interest on the June 1, 1973, issue of obligations would become taxable (since the $5 million limit would be exceeded) on the date of the merger.

Example (18)

In 1965 City I issues $10 million of industrial development bonds to construct and equip a factory for corporation Z. In 1975 the remaining principal amount of the bonds outstanding is $4.1 million. If I issues $4.5 million of bonds to redeem the balance of the prior issue, and for other purposes, such issue cannot qualify as an exempt small issue under section **103(b)(6)(D)** and paragraph (b)(2) of this section even though at the time of issue the interest on the 1965 bonds was tax-exempt since the prior issue must be one which qualified under section **103(b)(6)(A)** and this section. Further, the 1975 issue will be an issue of industrial development bonds notwithstanding the provisions of paragraph (d)(2) of § **1.103-7** which provides that certain bonds issued to refund an issue of obligations issued on or before April 30, 1968 (or January 1, 1969, in certain cases) will not be so treated. Paragraph (d)(2) of § **1.103-7** is not applicable because the 1975 issue makes funds available for a purpose other than the debt service obligation on the 1965 bonds.

Example (19)

In 1969 City J issues $4 million of industrial development bonds which qualify as an exempt small issue under section 103(b)(6)(A) pursuant to an election under section **103(b)(6)(D)** and paragraph (b)(2) of this section. In 1971, by reason of a $2 million addition to the factory built with the proceeds of the issue, the 1969 exempt small issue loses its tax-exempt status. In 1972, the

city issues a $5 million issue to redeem the prior 1969 issue. The redemption issue will not qualify as an exempt small issue since the prior 1969 issue did not continue to qualify under section **103(b)(6)(A)** and this section.

[T.D. **7199**, **37 FR 15494**, Aug. 3, 1972; **37 FR 16177**, Aug. 11, 1972; **37 FR 17826**, Sept. 1, 1972, as amended by T.D. **7511**, **42 FR 54285**, Oct. 5, 1977; T.D. **7840**, **47 FR 46084**, Oct. 15, 1982; **51 FR 16299**, May 2, 1986]

prior issue of obligations outstanding and allocable to Y; A, or B as test-period beneficiaries. Because X owns 100 percent of the shopping center, 100 percent of the 1986 issue ($9 million) is allocated to X. Therefore, for purposes of determining whether the 1986 issue exceeds the $40 million limitation of section 103(b)(15), the $30 million of outstanding prior issues must be added to the $9 million 1986 issue. Because Y leases 50 percent of the shopping center, 50 percent of the 1986 issue ($4.5 million) is allocated to Y. Although Y is related to X under section 103(b)(15)(E), the $4.5 million of the 1986 issue that is allocated to Y is not added to the $39 million allocated to X under paragraph (i)(4)(iv) of this section since such amount has already been allocated to X as owner of the shopping center. Because A and B each leases 25 percent of the shopping center, each is allocated 25 percent ($2.25 million) of the 1986 issue.

Example (2). The facts are the same as in *Example (1)* except that A owns a 60-percent interest in an airport hotel described in § 1.103-8(a)(2)(ii)(*d*) and, because of such ownership interest, is allocated $15 million of prior outstanding obligations described in section 103(b)(4)(D). In addition, County N issues $25 million of obligations described in section 103(b)(4)(E) on October 1, 1986, to finance construction of a solid-waste disposal facility that will be owned by C, A's wholly-owned subsidary corporation. In this case, with respect to the September 1, 1986 issue, A is allocated the $15 million prior issue that is outstanding with respect to A's share of the airport hotel bond and the $2.25 million that is A's allocable share of the September 1, 1986, issue for a total of $17.25 million. Because the solid waste disposal facility bonds had not yet been issued when the September 1, 1986, obligation was issued, no portion of the $25 million of obligations to finance C's solid-waste disposal facility will be treated as part of A's allocable obligations with respect to the September 1, 1986, issue even though A and C are related persons. In addition, even though A and C are related persons and even though on the date of issue of the solid-waste disposal bonds C will be allocated more than $40 million of outstanding obligations for purposes of section 103(b)(15) (including A's $17.25 million of outstanding prior obligations), the $40 million limitation of section 103(b)(15) does not render the interest on the October 1, 1986, bonds taxable since the October 1, 1986 issue, qualifies for tax exemption under section 103(b)(4), and the $40 million limitation of section 103(b)(15) does not apply to render taxable bonds issued under section 103(b)(4).

Example (3). On October 1, 1986, City K issues an $8 million issue of obligations exempt under section 103(b)(6) to finance acquisition of a newly-constructed manufacturing plant owned by Corporation L. On October 1, 1986, Corporation M has $35 million of prior outstanding obligations allocable to it under section 103(b)(15). On October 1, 1986, L has no prior outstanding obligations allocable to itself. On April 1, 1988, M acquires 100 percent of the stock of L, which still owns the plant financed by the 1986 issue. Since M and L became related to each other during the 3-year test period of the 1986 issue and L had not ceased to use the facility, the $8 million issue is allocated to M under section 103(b)(15). This allocation causes the 1986 issue to exceed the $40 million limitation of section 103(b)(15) and the interest upon the issue to become taxable on and after October 1, 1986. However, if at least $3 million of the 1986 issue or of other issues allocated to M are redeemed as soon as reasonably practicable, and no later than 180 days after M's acquisition of L's stock then the 1986 issue would not exceed the $40 million limitation.

Example (4). The facts are the same as in *Example (3)*, except the October 1, 1986, bonds were issued on January 1, 1985, the plant acquired with the proceeds of the issue was placed in service on January 1, 1985, and M had $39 million of prior outstanding obligations allocable to it on January 1, 1985. Because M and L became related to each other after the test period for the January 1, 1985, issue ended, M is not a test-period beneficiary, and the January 1, 1985, issue does not exceed the $40 million limitation of section 103(b)(15). However, if either M or L subsequently becomes a test-period beneficiary of an issue of obligations, then the outstanding principal amount of the January 1, 1985, issue and of the other issues allocable to M would be taken into account in applying the $40 million limitation to that issue.

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

[FR Doc. 86-3859 Filed 2-20-86; 8:45 am]

BILLING CODE 4830-01-M

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26 CFR Part 1

[LR-157-84, LR-59-74]

Income Taxes; $40 Million Limitation Upon Beneficiaries of Certain Tax-Exempt Bond Issues and Definition of the Term "Principal User" Public Hearing on Proposed Regulations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of public hearing on proposed regulations.

SUMMARY: This document provides notice of a public hearing on two proposed regulations. One of the two proposed regulations (LR-157-84) relates to certain industrial development tax-exempt bonds and to certain beneficiaries of such bond issues. The other proposed regulations (LR-59-74) define the term "principal user" for purposes of paragraphs (6) and (15) of section 103(b) of the Internal Revenue Code of 1954.

DATES: The public hearing will be held on Wednesday, June 4, 1986, beginning at 10:00 a.m. Outlines of oral comments must be delivered or mailed by Wednesday, May 21, 1986.

ADDRESS: The public hearing will be held in the I.R.S. Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. The requests to speak and outlines of oral comments should be submitted to the Commissioner of Internal Revenue, Attn: CC:LR:T (LR-157-84 and LR-59-74), Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Faye Easley of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224, telephone 202-566-3935 (not a toll-free call).

SUPPLEMENTARY INFORMATION: One of the two subjects of the public hearing is proposed regulations under section 103(b)(15) of the Internal Revenue Code of 1954. The proposed regulations appear in this issue of the Federal Register (FR Doc. 86-3859).

The second subject of the public hearing is proposed regulations under section 103(b)(6) of the Internal Revenue Code of 1954. The proposed regulations also appear in this issue of the Federal Register (FR Doc. 86-3858).

The rules of § 601.601(a)(3) of the "Statement of Procedural Rules" (26 CFR Part 601) shall apply with respect to the public hearing. Persons who submit written comments within the time prescribed in the notice of proposed rulemaking and who also desire to present oral comments at the hearing on the proposed regulations should submit, not later than Wednesday, May 21, 1986, an outline of the oral comments to be presented at the hearing and the time they wish to devote to each subject.

Each speaker will be limited to 10 minutes for an oral presentation exclusive of the time consumed by questions from the panel for the government and answers to these questions.

Because of controlled access restrictions, attendees cannot be admitted beyond the lobby of the Internal Revenue Building until 9:45 a.m.

An agenda showing the scheduling of the speakers will be made after outlines are received from the speakers. Copies of the agenda will be available free of charge at the hearing.

By direction of the Commissioner of Internal Revenue:

Paul A. Francis,

Acting Director, Legislation and Regulations Division.

[FR Doc. 86-3860 Filed 2-20-86; 8:45 am]

BILLING CODE 4830-01-M

26 CFR Part 1

[LR-59-74]

Income Taxes; Definition of the Term "Principal User"

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations which would define the term "principal user" for purposes of paragraphs (6) and (15) of section 103(b) of the Internal Revenue Code of 1954. The regulations would affect issuers, holders, and recipients of the proceeds of industrial development bonds issued under section 103(b)(6) of the Code.

DATES: Written comments must be delivered or mailed by April 22, 1986. The amendments are proposed to be effective after August 22, 1986 in determining the tax-exempt status of obligations issued after August 22, 1986.

ADDRESS: Send comments to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-59-74), Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: John A. Tolleris of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224 (Attention: CC:LR:T) (Telephone: 202-566-3590, not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed clarifying amendments to the Income Tax Regulations (26 CFR Part 1) under section 103(b)(6) of the Internal Revenue Code of 1954.

Explanation of Provisions

The amendments clarify the term "principal user" for purposes of applying the provisions of Code section 103(b)(6) and (15) and the regulations thereunder with respect to small issues of industrial development bonds. Section 103(b)(6) provides, among other things, that an issue of $1 million or less of industrial development bonds financing the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the depreciation allowance (or an issue to redeem such a prior issue) is not exempt from Federal taxation when the issue in question combined with the outstanding face amount of prior issues financing certain similar facilities exceeds $1 million; the facilities which are taken into account for this purpose are those the "principal user" of which is or will be the same or two or more related persons, and which are located within the same county or incorporated municipality.

Section 103(b)(6) also provides that, if an issuer makes the necessary election, the limit for an exempt small issue of industrial development bonds is increased from $1 million to $10 million. In such case, however, certain other amounts must also be aggregated with the issue of obligations in question for purposes of determining whether the $10 million limitation has been exceeded and whether the interest upon the issue of obligations in question is thus subject to Federal income taxation. The additional amounts to be taken into account are certain capital expenditures, made within a 6-year period beginning 3 years before the date of issue of the obligations in question and ending 3 years after the date of issue, with respect not only to the facility financed by the issue, with respect not only to the facility financed by the issue in question, but also with respect to other facilities within the same county or incorporated municipality of which the "principal user" is or will be the same person or a person related to the "principal user" of the facility financed with the issue of obligations in question.

The proposed regulations provide, in general, that the principal users are persons who for tax purposes currently hold more than a 10-percent ownership interest in a facility. In addition, lessees or sublessees who use a sufficiently valuable portion of the facility pursuant to a sufficiently long-term lease are also principal users. Persons with interests comparable to that of an owner or lessee who is a principal user and some purchasers of the output of certain facilities are also treated as principal users.

The proposed regulations provide that, when a facility has more than one principal user, certain issues of obligations with respect to all principal users must be aggregated with the issue of obligations in question for purposes of determining whether the $1 million or $10 million limitation has been exceeded. Similarly, if the $10 million limitation has been elected by the issuer, certain capital expenditures with respect to all principal users must also be aggregated to determine whether the $10 million limitation has been exceeded.

For purposes of aggregating issues of obligations or capital expenditures of persons who are principal users, only issues and capital expenditures with respect to persons who are principal users of the facility before the expiration of the test period described in section 103(b)(15(D) are aggregated. Accordingly, if a person who is a principal user of a facility financed by an exempt small issue becomes the principal user of another facility financed by a second exempt small issue more than 3 years after the later of the date of the second issue or the date the facility financed by the second issue was placed in service, the two issues are not aggregated. Similarly, capital expenditures during the 6-yeaar period described in section 103(b)(6)(D)(ii) with respect to a principal user are not taken into account if that person does not become a principal user of the facility until more than 3 years after the later of the date of the issue or the date the facility financed by the issue is first placed in service.

The test-period concept was adopted for purposes of section 103(b)(b)(6) for reasons of administrative convenience. The statutory reference to a person who "is or will be" a principal user could be construed as referring to a person who at any time is a principal user; as referring only to a person who is or is about to be a principal user on the date of issuance; or as referring to a person who becomes a principal user within some intermediate time period. In adopting the test-period concept, the Service attempted to reach a result which gives effect to the statutory language while also being administrable. Adoption of the tests period described in section 103(b)(15)(D) serves the additional function of limiting the period for determination of the principal user status to a single period for purposes of both paragraphs (6) and (15) of section 103(b).

The proposed regulations provide special rules for exempt persons, *i.e.*, State and local governments and organizations that are tax-exempt under section 501(c)(3), that are principal users of facilities financed with exempt small issues of industrial development bonds. For purposes of determining whether the small-issue limitation has been exceeded with respect to any facility of which an exempt person is a principal user, certain industrial development bonds issued with respect to the exempt person and, for purposes of the $10 million limitation, certain capital expenditures must be aggregated with the issue in question. This does not include capital expenditures with respect to other facilities used by the exempt person in an activity other than an unrelated trade or business (as defined by section 513).

Regulatory Flexibility Act

It is hereby certified that this proposed rule will not have a significant impact on a substantial number of small entities because the economic and any other secondary or incidental impact flows directly from the underlying statute. A regulatory flexibility analysis, therefore, is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Non-Applicability of Executive Order 12291

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

Comments—Public Hearing

Before adoption of these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held in accordance with the notice of hearing published in this issue of the Federal Register.

Drafting Information

The principal author of these proposed regulations is John A. Tolleris of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

List of Subjects in 26 CFR Parts 1.61–1.281–4

Income taxes, Taxable income, Deductions, Exemptions.

Proposed Amendments to the Regulations

The proposed amendments to 26 CFR Part 1 are as follows:

Par. 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. * * *

Par. 2. Section 1.103–10 is amended by adding a new sentence after the second sentence of paragraph (b)(2)(i); by deleting "(*e*)" and adding "(*f*)" in lieu thereof in the first sentence of paragraph (b)(2)(iv) introductory text and by adding a new subdivision (*f*) at the end of subdivision (iv) thereof; by adding two new sentences after the first sentence of paragraph (d)(1); by revising paragraph (d)(2)(ii); by adding two new flush sentences at the end of paragraph (d)(2); by revising the introductory text of paragraph (g); and by adding a new paragraph (h). The revised and added provisions read as follows:

§ 1.103–10 Exemption for certain small issues of industrial development bonds.

* * * * *

(b) *Small issue exemption.* * * *

(2) *$10 million or less.* (i) * * * All capital expenditures decribed in paragraph (b)(2)(ii) with respect to each principal user and each related person must be aggregated with the issue of obligations in question for purposes of determining whether the $10 million limitation of section 103(b)(6)(D) is exceeded. * * *

(iv) * * *

(*f*) A capital expenditure with respect to a facility other than the bond-financed facility ("other facility") is an excluded expenditure if the principal user of the other facility does not become a principal user of the facility financed by the proceeds of the issue in question ("bond-financed facility") until after the last day of the test period described in paragraph (i)(3)(ii) of this section. In addition, a capital expenditure with respect to an "other facility" becomes an excluded expenditure on and after the date the principal user of the other facility ceases to use the bond-financed facility; if, however, the issue financing the bond-financed facility lost its tax-exempt status on or before that date, this sentence will not apply to restore its tax-exempt status. * * *

* * * * *

(d) *Certain prior issues taken into account*—(1) *In general.* * * * Thus, the outstanding face amount of all prior issues specified in paragraph (d)(2) with respect to each principal user and each related person and taken into account under this paragraph (d)(1) must be aggregated with the issue of obligations in question for purposes of determining whether the $1 million limitation of section 103(b)(6)(A) or the $10 million limitation of section 103(b)(6)(D) has been exceeded with respect to the issue in question. The outstanding face amount of the prior exempt small issue is the principal amount outstanding at the time of issuance of the subsequent exempt small issue. * * *

(2) *Prior issues specified.* * * *

(ii) The principal user of the facilities described in paragraph (d)(2)(i) of this section is the same person or two or more related persons (as defined in section 103(b)(6)(C) and in paragraph (e) of this section) at any time on or after the date of issue of the subsequent issue but before the expiration of the test period described in paragraph (i)(3)(ii) of this section with respect to the subsequent issue.

The loss of tax exemption with respect to the interest on the subsequent issue shall be effective on the date of issue of the subsequent issue. For purposes of this paragraph (d), when a person ceases to use a facility financed by either the prior issue or the subsequent issue, the prior issue will no longer be taken into account under paragraph (d)(1) with respect to the subsequent issue; if, however, the subsequent issue loses its tax-exempt status on or before the date the person ceases to use either of the facilities described in this subparagraph, this paragraph will not apply to restore the tax-exempt status of the subsequent issue. * * *

* * * * *

(g) *Examples.* The application of the rules contained in section 103(b)(6) and in paragraphs (a) through (f) of this section are illustrated by the following examples: * * *

* * * * *

(h) *Rules relating to principal users*—(1) *Definition of principal user.* For purposes of section 103(b)(6) and § 1.103–10, the term "principal user" means a person who is a principal owner, a principal lessee, a principal output purchaser, or an "other" principal user. The term "principal user" also includes a person who is related to another person who is a principal user under section 103(b)(6)(C) and paragraph (e) of this section, unless the other person ceased to use the facility before the two persons become related. For purposes of this paragraph (h)—

(i) *Principal owner.* A principal owner is a person who at any time holds more than a 10-percent ownership interest (by value) in the facility or, if no person holds more than a 10-percent ownership interest, then the person (or persons in the case of multiple equal owners) who holds the largest ownership interest in the facility. A person is treated as holding an ownership interest if such person is an owner for Federal income tax purposes generally. Thus, for example, where a facility constructed on land subject to a ground lease has an economic useful life less than the noncancellable portion of the term of the ground lease, the ground lessor shall not, merely by reason of that reversionary interest, be treated as the principal user of the facility before the ground lease expires.

(ii) *Principal lessee.* A principal lessee is a person who at any time leases more than 10 percent of the facility (disregarding portions used by the

lessee under a short-term lease). The portion of a facility leased to a lessee is generally determined by reference to its fair rental value. A short-term lease is one which has a term of one year or less, taking into account all options to renew and reasonably anticipated renewals.

(iii) *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, unless the total output purchased by such person during each one-year period beginning with the date the facility is placed in service is 10 percent or less of the facility's output during each such period.

(iv) *Other principal user.* An "other" principal user is a person who enjoys a use of the facility (other than a short-term use) in a degree comparable to the enjoyment of a principal owner or a principal lessee, taking into account all the relevant facts and circumstances, such as the person's participation in control over use of the facility or its remote or proximate geographic location. For example, a party to a contract who would be treated as a lessee using more than 10 percent of a facility on a long-term basis but for the special rules of section 7701(e) (3) and (5) (relating to service contracts for certain energy and water facilities and low-income housing) is an "other" principal user. A short-term use means use that is comparable to use under a short-term lease.

(2) *Operating rules.* (i) In determining whether a person is a principal user of a facility, it is irrelevant where in a chain of use such person's use occurs. For example, where a sublessee subleases more than 10 percent of a facility from a lessee, both the lessee and the sublessee are principal lessees.

(ii) In determining whether a person owns or uses more than 10 percent of a facility or whether he uses it for more than one year, the person is treated as owning or using the facility to the extent that any person related to such person under section 103(b)(6)(C) and paragraph (e) of this section owns or uses the facility. For purposes of the preceding sentence, the term "use" includes use pursuant to an output purchase arrangement.

(iii) Co-owners or co-lessees who are collectively treated as a partnership subject to subchapter K under section 761(a) are not treated as principal users merely by reason of their ownership of partnership interests; such ownership is, however, taken into account in determining whether persons are related under section 103(b)(6)(C) and paragraph (e) of this section.

(iv) For purposes of this section, a principal user of a facility is treated as ceasing to use the facility when he ceases to own, lease, purchase the output of, or otherwise use the facility, as the case may be. A person who is a principal user of a facility because he is related to another person who is a principal user is treated as ceasing to use the facility when the other person ceases to use the facility or when the two persons cease to be related. A principal user who ceases to use a facility continues to be a principal user. See, however, paragraph (b)(2)(iv)(*f*) of this section (relating to excluded expenditures), paragraph (d)(2) (relating to prior issues), and paragraph (h)(1) (defining principal user), which may apply when a principal user ceases to use a facility.

(3) *Special rule for exempt persons.* If an exempt person, as defined in section 103(b)(3) and § 1.103–7 (b)(2), is a principal user of a facility financed with an issue of obligations described in section 103(b)(6), the following amounts must be aggregated with the issue in determining whether the $1 million limit of section 103(b)(6)(A) or the $10 million limit of section 103(b)(6)(D) has been exceeded:

(i) The outstanding face amount of any prior exempt small issue of industrial development bonds described in paragraph (d) of this section that financed a facility of which the exempt person is a principal user,

(ii) For purposes of the $10 million limitation, capital expenditures described in paragraph (b)(2) (ii) of this section paid or incurred with respect to other facilities used by the exempt person in an unrelated trade or business (within the meaning of section 513 and § 1.513–1) and of which the exempt person is a principal user, and

(iii) Any section 103(b)(6)(D) capital expenditures paid or incurred with respect to the facility financed by the issue in question.

(4) *Examples.* The application of the rule of section 103(b)(6) and this paragraph (h) is illustrated by the following examples:

Example (1). On September 1, 1986, City L, after making the section 103(b)(6)(D) election, issues $6 million of obligations to finance the costs of acquiring a newly constructed warehouse within City L, owned by Corporation Z, a non-exempt person, which thus is a principal user of the warehouse. Beginning on September 1, 1986, the entire warehouse is leased to Corporation Y, an unrelated non-exempt person, for a 2-year term; thus, Y is also a principal user of the warehouse. On June 30, 1988, Y ceases to lease the warehouse. On October 1, 1988, Y incurs $20 million of capital expenditures in connection with its purchase of an office building in City L. Although Y continues to be a principal user of the warehouse under paragraph (h)(2)(iv) of this section, Y's capital expenditures after the date it ceases to use the warehouse are excluded expenditures under paragraph (b)(2)(iv)(*f*) of this section. Accordingly, the $20 million Y incurred with respect to the office building is not taken into account for purposes of determining whether the $10 million limitation of section 103(b)(6)(D) has been exceeded.

Example (2). The facts are the same as in Example (1), except that on October 1, 1985, City L issued an exempt small issue to finance acquisition of a newly constructed office building in the amount of $5 million, of which $4 million is outstanding on September 1, 1988. On December 1, 1988, Corporation Z leases 15 percent (by fair rental value) of the office building financed by the 1985 issue for a 2-year term. Thus, beginning on December 1, 1988, Z is a principal user of the office building. On December 1, 1988, Z still owns the warehouse financed by the 1986 issue. Because Z became a principal user of the office building before the end of the 3-year test period described in paragraph (i)(3)(ii) of this section with respect to the 1985 issue, the $4 million outstanding amount of the 1985 issue must be aggregated with the $6 million 1986 issue for purposes of determining whether the 1986 issue has exceeded the $10 million limitation of section 103(b)(6)(D). Because the sum of the two issues ($4 million of the prior 1985 issue outstanding on September 1, 1988, and the $6 million subsequent issue issued on September 1, 1986) exceeds $10 million, the interest on the 1986 issue ceases to be tax-exempt on September 1, 1988. Had Z's lease begun after September 1, 1989, the two issues would not have to be aggregated.

Example (3). On June 1, 1985, City O issues $15 million of its obligations to finance an expansion of a hospital owned by H, an organization described in section 501(c)(3) exempt from taxation under section 501(a). None of the proceeds of the issue will be used by H in an unrelated trade or business or in the trade or business of non-exempt persons. On November 1, 1986, City O, after making the section 103(b)(6)(D) election, issues $5 million of its obligations to construct a medical office building which will be owned by H for Federal income tax purposes and which will be entirely leased (for terms in excess of one year) to physicians, none of whom will lease over 10 percent of the building by value. On July 1, 1987, H incurs a $500,000 capital expenditure for permanent improvements to the medical office building. In addition, on August 1, 1987, W, a non-exempt person related to H, incurs a $1 million capital expenditure with respect to a facility that W owns within City O and uses in its trade or business. For purposes of determining whether the $10 million limitation of section 103(b)(6)(D) has been exceeded with respect to the November 1, 1986, issue for the medical office building, H must take into account the $5 million issue, the $500,000 of capital expenditures made with respect to the medical office building, and W's $1 million capital expenditure.

Because the sum of these amounts is less than $10 million, interest on the issue does not cease to be tax-exempt. H is not required to take into account the June 1, 1985, issue financing the hospital expansion because that issue is not an exempt small issue as defined in section 103(b)(6) (see paragraph (h)(3)(i) of this section) and because the cost of the facility financed by the June 1, 1985, issue is neither a section 103(b)(6)(D) capital expenditure with respect to the medical office building owned by H (see paragraph (h)(3)(ii) of this section) nor a section 103(b)(6)(D) capital expenditure for a separate facility used by H in an unrelated trade or business (see paragraph (h)(3)(ii) of this section).

* * * * *

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

[FR Doc. 86-3858 Filed 2-20-86; 8:45 am]

BILLING CODE 4830-01-M

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[A-9-FRL-2972-4]

Approval and Promulgation of Implementation Plans; Air Pollution Control Regulations, State of California

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice of proposed rulemaking.

SUMMARY: The Sanat Barbara County Air Pollution Control District (SBCAPCD) adopted a New Source Review Rule on April 2, 1984. The Rule contains provisions comparable to EPA's requirements for both New Source Review (NSR) and Prevention of Significant Deterioration (PSD). It regulates construction and operation of new and modified major stationary sources of both nonattainment and attainment pollutants. The District adopted the Rule to satisfy conditions on the approval of its previous NSR Rule and to obtain authority from EPA to issue permits for PSD. This Rule was submitted to EPA as a State Implementation Plan (SIP) revision on May 21, 1984. EPA is proposing to approve the Rule but to disapprove four exemptions. The approval of the major portions of Rule 205.C is contingent on resolution of issues necessary to fully meet EPA's requirements. The District has been extremely cooperative in resolving EPA's concerns.

DATE: Comments may be submitted up to March 24, 1986.

ADDRESSES: Comments may be sent to: Regional Administrator, Attn: Air Management Division, New Source Section (A-3-1), Environmental Protection Agency, Region 9, 215 Fremont Street, San Francisco, CA 94105.

Copies of the District's Rule and EPA's Evaluation Report are available for public inspection during normal business hours at the EPA Region 9 office listed above and at the following locations:

California State Air Resources Board, Public Information Office, 1102 "Q" Street, Sacramento, CA 95814

Santa Barbara County Air Pollution Control District, Health Care Service, 315 Camino del Remedio, Santa Barbara, CA 93110.

FOR FURTHER INFORMATION CONTACT: Willard Chin, State Liaison Section (A-2-2), Air Management Division, U.S. Environmental Protection Agency, 215 Fremont Street, San Francisco, CA 94105 (415) 974-8071.

SUPPLEMENTARY INFORMATION:

Background

On May 5, 1982 (47 FR 19330), EPA approved the Nonattainment Area Plan and NSR Rule for the Santa Barbara County APCD, subject to certain conditions. One of the conditions was that the NSR Rule be revised to satisfy EPA's regulations of August 7, 1980 (40 CFR 51.18).

The new Rule 205.C was written to satisfy the NSR condition imposed by EPA in 1982 and also to serve as the basis for securing full authority from EPA for issuing PSD permits. The Rule follows the NSR/PSD Rule developed by the California Air Pollution Control Officers' Association (CAPCOA) and the California Air Resources Board. It combines NSR and PSD in a single review program and includes specific procedures to plan and regulate sources in areas where clean air is particularly important. EPA requires NSR Rules for pollutants of which an area is designated nonattainment. PSD rules apply to pollutants for which an area is designated attainment. The entire County is attainment for nitrogen oxides, carbon monoxide and unclassified for sulfur dioxide. The Southern Coastal area of the County is nonattainment for ozone and the Santa Maria area is nonattainment for TSP.

NSR—Part D of the Clean Air Act (Sections 171 to 173) and EPA regulations (40 CFR 51.18) define the requirements for NSR programs. The most important requirements are that the rules require applicants for new sources or modifications to: (a) Meet the Lowest Achievable Emission Rate, (b) provide emission reductions (offsets) at least equal to the proposed emission increases and consistent with RFP, and (c) certify that all of their sources in the State comply with all emission limitations. Where growth allowances are provided, offsets may not be needed. Santa Barbara County currently administers the NSR program under its conditionally approved Rule.

PSD—Subpart 1 of Part C of the Clean Air Act (Sections 160 to 169) and EPA regulations (40 CFR 51.24) contain requirements for PSD. The PSD requirements apply to criteria pollutants which are designated attainment and to the non-criteria pollutants which are also regulated under Sections 111 and 112 of the Act. Santa Barbara APCD is currently administering the PSD program under a delegation agreement with EPA. When PSD regulations for the Santa Barbara County are approved, the delegation agreement will terminate. The District will continue to issue federally valid PSD permits, but the Santa Barbara rule will replace 40 CFR 52.21 as the federally enforecable PSD regulation. The primary requirements for a PSD program include: (1) The application of "Best Available Control Technology" (BACT) to new or modified major stationary sources; (2) requiring applicants to demonstrate that the increased emissions will not cause violations of any National Ambient Air Quality Standard (NAAQS) or air quality increments; and (3) requiring protection of Class I areas, where very little air quality deterioration is allowed.

Description of Regulations

The District adopted Rule 205.C on April 2, 1984. It was submitted to EPA by the Governor's designee as an official SIP revision on May 21, 1984. The new Rule 205.C adopted by the District supersedes and entirely replaces the old rule.

Evaluation

EPA has evaluated Rule 205.C against its NSR and PSD approval criteria. The District's Rule satisfies EPA's requirements, except as described below and in the Evaluation Report. The Rule will: (1) Require preconstruction review of those sources for which EPA requires it; (2) require BACT and air quality protection consistent with EPA's PSD requirements; and (3) require certification of statewide compliance, application of LAER, and offsets in a manner consistent with EPA's NSR requirements.

EPA found several deviations from EPA requirements. Specifically, EPA

Attachment 14

Internal Revenue Code, § 168. Accelerated Cost Recovery System

168(g)
Alternative Depreciation System For Certain Property

168(g)(5)
Tax-Exempt Bond Financed Property — For purposes of this subsection—

168(g)(5)(A)
In General — Except as otherwise provided in this paragraph, the term "tax-exempt bond financed property" means any property to the extent such property is financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section **103(a)**.

168(g)(5)(B)
Allocation Of Bond Proceeds — For purposes of subparagraph **(A)**, the proceeds of any obligation shall be treated as used to finance property acquired in connection with the issuance of such obligation in the order in which such property is placed in service.

168(g)(5)(C)
Qualified Residential Rental Projects — The term "tax-exempt bond financed property" shall not include any qualified residential rental project (within the meaning of section **142(a)(7)**).

Attachment 15

Department of the Treasury
Internal Revenue Service
Notice

NOTICE 2011-63, 2011-34 I.R.B. 172 (8/22/2011)

Part III - Administrative, Procedural, and Miscellaneous

State and Local Bonds: Volume Cap and Timing of Issuing Bonds

Notice 2011-63

SECTION 1. PURPOSE

This Notice provides supplemental guidance on the determination of when State and local bonds (as defined in **§103(c)** of the **Internal Revenue Code** (the "Code")) are considered "issued" for purposes of volume cap limitations on private activity bonds under **§146** and other bond volume caps and limitations under Federal law. This Notice amends and supplements **Notice 2010-81**.

SECTION 2. BACKGROUND

In **Notice 2010-81**, *2010-50 I.R.B. 825* (December 13, 2010), the Treasury Department and the IRS provided guidance regarding when State and local bonds (as defined in *§103(c)*) are considered issued for purposes of various deadlines on issuing bonds. Under the general rule set forth in **Notice 2010-81**, a bond is treated as issued on the "issue date" of the "bond" under **§1.150-1(b)** of the Income Tax Regulations (as contrasted with the "issue date" of the "issue" that includes the bond). This analysis particularly affects certain financing structures, such as draw-down loans and commercial paper, in which bonds of the same issue are issued at different times. **Notice 2010-81** applies to various types of deadlines on issuing bonds, including, among others, volume caps on private activity bonds under **§146** and other bond volume caps under Federal law such as national limitations for the amount and timing of bonds issued as Qualified Zone Academy Bonds or Qualified Gulf Opportunity Zone Bonds.

In general, **§146** imposes annual State volume caps on private activity bonds and allows issuers to "carry forward" unused volume cap for use during a three-year carryforward period after the calendar year in which the original bond volume cap authorization arose. Other volume caps on bonds issued by State or local governments may apply in a similar manner, subject to different carryforward periods based on statutory deadlines, depending on the particular program.

The Treasury Department and the IRS have received comments that prior to **Notice 2010-81**, various States and issuers treated a bond as issued on other than its issue date as provided in **Notice 2010-81**, creating concerns for the treatment of draw-down loans and commercial paper for purposes of allocation, use, and administration of volume caps on private activity bonds under **§146**.

SECTION 3. SCOPE AND APPLICATION

01. *Bond Issuance for Purposes of Volume Cap Allocations*. Solely for purposes of the private activity bond volume cap under **§146** and other bond volume caps on State and local bonds under Federal law, an issuer may treat a bond as issued either: (1) on the issue date of the bond under the general rule in **Notice 2010-81** or (2) in the alternative, on the issue date of the issue provided that the issuer meets the additional requirements of this §3.01. An issuer that treats the bonds as issued on the issue date of the issue may not retroactively alter such treatment.

The issuer meets the additional requirements of this §3.01 if the issuer issues all of the bonds of the issue, determined for this purpose by treating each bond of the issue as issued on the issue date of that bond under the general rule in **Notice 2010-81**, by no later than the earlier of: (i) the statutory deadline for issuing the bonds or (ii) the end of the maximum carryforward period for unused volume cap under the applicable statute, treating all of the unused volume cap for the issue as volume cap arising in the year in which the issue date of the issue occurs.

02. *Example*. In *Year 1*, an issuer receives a $1 million volume cap allocation from state volume cap that arose in *Year 1* under **§146** for a draw-down bond issue of exempt facility bonds under **§142** and issues $50,000 in *Year 1*. Thus the issue date of the issue under **§1.150-1(c)(4)(i)** occurs in *Year 1*. In *Years 2 through 4*, the issuer issues the $950,000 in remaining bonds of the issue. Under the general rule in **Notice 2010-81**, $50,000 of the bonds would be treated as issued in *Year 1* on the issue date of those bonds, $50,000 of volume cap would be treated as used in *Year 1*, the remaining $950,000 of the bonds would be treated as issued upon funding of the draws in *Years 2 through 4*, respectively, and the issuer would use carryforward volume cap (or obtain additional volume cap) to cover those remaining bonds. Under the alternative option, for volume cap purposes, if the issuer in *Year 1* treated all of the $1 million in bonds as issued on the issue date of the issue, the entire $1 million of bonds of the issue is treated as issued on the issue date of the issue and the entire $1 million of volume cap is treated as used in *Year 1*. If the $1 million in volume cap in *Year 1* were a carryforward volume cap, the issuer would have three years from *Year 1* to use the carryforward because the alternative option in §3.01 would treat the amount of the carryforward as volume cap arising in *Year 1* (the year in which the issue date of the issue occurs). If the bonds were small issue bonds under **§144(a)**, the alternative option would not be available because under **§146** there is no carryforward period for unused volume cap for small issue bonds.

.03. *Information Reporting*. **Section 1.149(e)-1(e)(2)(ii)** of the Income Tax Regulations provides guidance on applicable information reporting requirements under **§149(e)** for State and local bonds issued as draw-down bonds and commercial paper. For such information reporting purposes, in the case of issues issued after August 3, 2011, issuers who apply the alternative option under §3.01 of this Notice should write or type "Filed in Accordance with Notice 2011-63 State and Local Bonds: Volume Cap and Timing of Issuing Bonds" at the top of the applicable information reporting return. Pursuant to **§1.149(e)-1(e)(2)(ii)**, amended information reporting returns are not required for this purpose for bonds treated as issued under this notice before August 3, 2011.

SECTION 4. EFFECT ON OTHER DOCUMENTS

This Notice amends and supplements **Notice 2010-81**.

SECTION 5. DRAFTING INFORMATION

The principal authors of this Notice are Vicky Tsilas and Timothy L. Jones of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this Notice, contact Vicky Tsilas at (202) 622-3980 (not a toll-free call).

Attachment 16

Internal Revenue Code, § 7701. Definitions

7701(o)
Clarification Of Economic Substance Doctrine

7701(o)(1)
Application Of Doctrine — In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

7701(o)(1)(A)
— the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

7701(o)(1)(B)
— the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

7701(o)(2)
Special Rule Where Taxpayer Relies On Profit Potential

7701(o)(2)(A)
In General — The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs **(A)** and **(B)** of paragraph **(1)** are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

7701(o)(2)(B)
Treatment Of Fees And Foreign Taxes — Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph **(A)**. The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

7701(o)(3)
State And Local Tax Benefits — For purposes of paragraph **(1)**, any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

7701(o)(4)
Financial Accounting Benefits — For purposes of paragraph **(1)(B)**, achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

7701(o)(5)
Definitions And Special Rules — For purposes of this subsection—

7701(o)(5)(A)
Economic Substance Doctrine — The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

7701(o)(5)(B)
Exception For Personal Transactions Of Individuals — In the case of an individual, paragraph **(1)** shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

7701(o)(5)(C)
Determination Of Application Of Doctrine Not Affected — The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

7701(o)(5)(D)
Transaction — The term "transaction" includes a series of transactions.