Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

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Person to Contact:

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Refer Reply to:
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Date: NOV 24 1998

Legend:

Issuer =

Borrower =

Bonds =

Equipment =

Lessor =

$X =

$Y =

Site =

Dear

This is in response to a letter submitted on behalf of Issuer and Borrower by their authorized representative requesting a ruling concerning whether certain expenditures must be included in the aggregation of capital expenditures for purposes of § 144(a)(4) of the Internal Revenue Code under the circumstances described below.

FACTS

The following facts have been represented. Issuer proposes to issue the Bonds and loan $X of the proceeds of the Bonds to Borrower to acquire Equipment. Borrower is a corporation which will own the Equipment and install the Equipment at Site, which will be leased from Lessor. The term of the lease is 10 years with four successive 5-years renewal options. You represent that the Equipment will be a manufacturing facility.

Lessor is a corporation unrelated to Borrower. During the 3-year period prior to the issuance of the Bonds, Lessor expects to incur capital expenditures chargeable to its capital account of approximately $Y, with respect to construction of Site. These expenditures will not be financed with proceeds of the Bonds. The sum of $X and $Y exceeds $10,000,000.

Issuer requests a ruling on whether the $ Y in capital expenditures made by Lessor with respect to Site are to be included in the calculation of the $10,000,000 limitation under § 144(a)(4).

LAW AND ANALYSIS

Section 103(a) provides that, except as provided in subsection (b), gross income does not include interest on any state or local bond. Subsection (b) provides, in part, that subsection (a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141(e) provides, in part, that the term "qualified bond" includes any private activity bond if such bond is a qualified small issue bond. Section 144(a)(1) of the Code provides, in part, 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.

Under § 144(a)(4), an issuer may elect a qualified small issue limit of $10,000,000 in lieu of the $1,000,000 limit. The $10,000,000 limit is determined by taking into account the face amount of such issue, certain prior exempt small issues, and the aggregate amount of capital expenditures with respect to certain facilities paid or incurred during the 6-year period beginning three years before the date of such issue and ending three years after such date (and financed otherwise than out of the proceeds of outstanding issues to which § 144(a)(1) [or the corresponding

provision of prior law - § 103(b)(6)(A) of the 1954 Code] applies). The facilities to be taken into account are those facilities located in the same incorporated municipality or located in the same county (but not in any incorporated municipality) the principal user of which is or will be the same person or two or more related persons.

The conference report accompanying the Tax Reform Act of 1986 states with regard to the tax-exempt bond provisions that "The conferees intend that, to the extent not amended, all principles of present law continue to apply under the reorganized provisions." 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-686 (1986), 1986-3 (Vol. 4) C.B. 686. Since § 144(a)(4) of the 1986 Code is substantially the same as § 103(b)(6) of the 1954 Code, it is appropriate to rely upon the principles of § 1.103-10(b)(2) of the Income Tax Regulations in applying § 144(a)(4).

Section 1.103-10(b)(2)(ii) of the Income Tax Regulations provides that an expenditure is a capital expenditure for purposes of the $10,000,000 limit only if: (a) the capital expenditure was financed other than out of the proceeds of issues taken into account under § 1.103-10(b)(2)(i)(a); (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; (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 the incorporated municipalities in the 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 the person is the principal user of the facility or a related person).

In Rev. Rul. 85-145, 1985-2 C.B. 37, a landlord incurred capital expenditures in connection with a facility, 75% of which was leased to Corporation X. These expenditures were not financed with tax-exempt bonds (and benefitted only tenants other than Corporation X). Corporation X proposed to purchase land and build a building at a different location in the same city as the leased building. After completion of the new building, Corporation X would vacate the leased building. Corporation X sought to have its new facilities financed with an issuance of small issue bonds. Landlord's capital expenditures on the leased building were to be incurred within three years of the proposed issue date of the small issue bonds. The ruling concludes that

the landlord's expenditures on the leased building are included in the aggregation for purposes of the $10,000,000 capital expenditure rule because (1) Corporation X will be the principal user of the facilities to be acquired and built with the proposed tax-exempt small issue bonds, (2) Corporation X is a principal user of the leased building, (3) the leased building and the new building will be in the same city, and (4) the expenditure with respect to the leased building is a capital expenditure and would be made within three years of the proposed issue date of the small issue bonds.

In this case the $Y capital expenditures incurred by Lessor on the Site will not be financed from the Bonds. These expenditures will be incurred within three years of the proposed issue date of the Bonds. Borrower will be a principal user of the proposed bond-financed Equipment, because it will own the Equipment, and of Site, because it will lease Site. Both the Equipment and Site are located at the same location. The $Y expenditures are properly chargeable to the Lessor's capital account. Accordingly, Lessor's expenditures of $ Y on Site will be included in the aggregation of capital expenditures under § 144(a)(4).

CONCLUSION

Based on the information submitted, Lessor's $Y of capital expenditures on the Site, if not financed by tax-exempt obligations described in § 144(a)(1), are aggregated with the face amount of the Bonds for purposes of determining whether the $10,000,000 limitation in § 144(a)(4) is exceeded. Since the sum of the face amount of the Bonds and $Y exceeds $10,000,000, the Bonds will not be qualified small issue bonds within the meaning of § 144(a) of the Code.

Except as specifically ruled above, no opinion is expressed on the transaction under any other provision of the Internal Revenue Code, including §§ 103 and 144(a), except as specified above. Specifically, no comment is made regarding whether some or any of the bond-financed facilities will be considered manufacturing facilities or facilities "related or ancillary" to manufacturing.

This ruling is directed only to the persons which requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by adoption of temporary

or final regulations, to the extent the regulations are inconsistent with any conclusion in the ruling. See section 12.04 of Rev. Proc. 98-1, 1998-1 I.R.B. 7. However, when the criteria in section 12.05 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By: _____
Rebecca L. Harrigal
Chief, Branch 5

Enclosure:
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