(2) Employee treated as zone resident.
(3) Resident employee percentage.
(f) Application to pooled financing bond and loan recycling programs.
(g) Limitation on amount of bonds.
(h) Original use requirement for purposes of qualified zone property.
(i) Land.
(j) Principal user.
(k) Treatment as separately incorporated business.
(l) Substantially all.
(m) Application of sections 142 and 146 through 150.
(a) Scope. This section contains rules relating to tax-exempt bonds under section 1394 (enterprise zone facility bonds) to provide enterprise zone facilities in both empowerment zones and enterprise communities (zones). See sections 1394, 1397B, and 1397C for other rules and definitions.
(b) Period of compliance—(1) In general. Except as provided in paragraphs (b)(2) and (c) of this section, the requirements under sections 1394 (a) and (b) applicable to enterprise zone facility bonds must be complied with throughout the greater of the following—
   (i) The remainder of the period during which the zone designation is in effect under section 1391 (zone designation period);
   (ii) The period that ends on the weighted average maturity date of the enterprise zone facility bonds.
(2) Compliance after an issue is retired. Except as provided in paragraph (c)(3) of this section, the requirements applicable to enterprise zone facility bonds do not apply to an issue after the date on which no enterprise zone facility bonds of the issue are outstanding.
(3) Deemed compliance—(i) General rule. An issue is deemed to comply with the requirements of sections 1394 (a) and (b) if—
   (A) The issuer and the principal user in good faith attempt to meet the requirements of sections 1394 (a) and (b) throughout the period of compliance required under this section; and
   (B) Any failure to meet these requirements is corrected within a one-year period after the failure is first discovered.
   (ii) Exception. The provisions of paragraph (b)(3)(i) of this section do not apply to the requirements of section 1397B(d)(5)(A) (relating to certain prohibited business activities).
   (iii) Good faith. In order to satisfy the good faith requirement of paragraph (b)(3)(i)(A) of this section, the principal user must at least annually demonstrate to the issuer the principal user’s monitoring of compliance with the requirements of sections 1394 (a) and (b).
(c) Special rules for requirements of sections 1397B and 1397C—(1) Start of compliance period. Except as provided in paragraph (c)(2) of this section, the requirements of sections 1397B (relating to qualification as an enterprise zone business) and 1397C (relating to satisfaction of the rules for qualified zone property) do not apply prior to the initial testing date (as defined in paragraph (c)(4) of this section) if—
   (i) The issuer and the principal user reasonably expect on the issue date of the enterprise zone facility bonds that those requirements will be met by the principal user on or before the initial testing date; and
   (ii) The issuer and the principal user exercise due diligence to meet those requirements prior to the initial testing date.
(2) Compliance period for certain prohibited activities. The requirements of
section 1397B(d)(5)(A) (relating to certain prohibited business activities) must be complied with throughout the term of the enterprise zone facility bonds.

(3) Minimum compliance period. The requirements of sections 1397B(b) or (c) and 1397C must be satisfied for a continuous period of at least three years after the initial testing date, notwithstanding that—

(i) The period of compliance required under paragraph (b)(1) of this section expires before the end of the three-year period; or

(ii) The enterprise zone facility bonds are retired before the end of the three-year period.

(4) Initial testing date—(i) In general. Except as otherwise provided in paragraph (c)(4)(ii) of this section, the initial testing date is the date that is 18 months after the later of the issue date of the enterprise zone facility bonds or the date on which the financed property is placed in service; provided, however, it is not later than—

(A) Three years after the issue date; or

(B) Five years after the issue date, if the issue finances a construction project for which both the issuer and a licensed architect or engineer certify on or before the issue date of the enterprise zone facility bonds that more than three years after the issue date is necessary to complete construction of the project.

(ii) Alternative initial testing date. If the issuer identifies as the initial testing date a date after the issue date of the enterprise zone facility bonds and prior to the initial testing date that would have been determined under paragraph (c)(4)(i) of this section, that earlier date is treated as the initial testing date.

(d) Testing on an average basis. Compliance with each of the requirements of section 1397B(b) or (c) is tested each taxable year. Compliance with any of the requirements may be tested on an average basis, taking into account up to four immediately preceding taxable years plus the current taxable year. The earliest taxable year that may be taken into account for purposes of the preceding sentence is the taxable year that includes the initial testing date. A taxable year is disregarded if the part of the taxable year that falls in a required compliance period does not exceed 90 days.

(e) Resident employee requirements—(1) Determination of employee status. For purposes of the requirement of section 1397B(b)(6) or (c)(5) that at least 35 percent of the employees are residents of the zone, the issuer and the principal user may rely on a certification, signed under penalties of perjury, that the principal resident employee requirements—

(i) The certification provides to the principal user the address of the employee's principal residence; and

(ii) The employee is required by the certification to notify the principal user of a change of the employee's principal residence; and

(iii) Both the issuer and the principal user have actual knowledge that the principal residence set forth in the certification is not the employee's principal residence.

(2) Employee treated as zone resident. If an issue fails to comply with the requirement of section 1397B(b)(6) or (c)(5) because an employee who initially resided in the zone moves out of the zone, that employee is treated as still residing in the zone if—

(i) That employee was a bona fide resident of the zone at the time of the certification described in paragraph (e)(1) of this section; and

(ii) That employee continues to perform services for the principal user in an enterprise zone business and substantially all of those services are performed in the zone; and

(iii) A resident of the zone meeting the requirements of section 1397B(b)(5) or (c)(4) is hired by the principal user for the next available comparable (or lesser) position.

(3) Resident employee percentage. For purposes of meeting the requirement of section 1397B(b)(6) or (c)(5) that at least 35 percent of the employees of an enterprise zone business are residents of a zone, paragraphs (e)(3)(i) and (ii) of this section apply.

(i) The term employee includes a self-employed individual within the meaning of section 401(c)(1).

(ii) The resident employee percentage is determined on any reasonable basis
consistently applied throughout the period of compliance required under this section. The per-employee fraction (as defined in paragraph (e)(3)(i)(A) of this section) or the employee actual work hour fraction (as defined in paragraph (e)(3)(i)(B) of this section) are both reasonable methods. (A) The term per-employee fraction means the fraction, the numerator of which is, during the taxable year, the number of employees who work at least 15 hours a week for the principal user, who reside in the zone, and who are employed for at least 90 days, and the denominator of which is, during the same taxable year, the aggregate number of all employees who work at least 15 hours a week for the principal user and who are employed for at least 90 days. (B) The term employee actual work hour fraction means the fraction, the numerator of which is the aggregate total actual hours of work for the principal user of employees who reside in the zone during a taxable year, and the denominator of which is the aggregate total actual hours of work for the principal user of all employees during the same taxable year. (g) Limitation on amount of bonds—(1) Determination of outstanding amount. Whether an issue satisfies the requirements of section 1394(c) (relating to the $3 million and $20 million aggregate limitations on the amount of outstanding enterprise zone facility bonds) is determined as of the issue date of that issue, based on the issue price of that issue and the adjusted issue price of outstanding enterprise zone facility bonds. Amounts of outstanding enterprise zone facility bonds allocable to any entity are determined under rules contained in section 144(a)(10)(C) and the underlying regulations. Thus, the definition of principal user for purposes of section 1394(c) is different from the definition of principal user for purposes of paragraph (j) of this section. (2) Pooled financing bond programs—(i) In general. The limitations of section 1394(c) for an issue for a pooled financing bond program are determined with regard to the amount of the actual loans to enterprise zone businesses rather than the amount lent to intermediary lenders as defined in paragraph (g)(2)(ii) of this section. This paragraph (g)(2) applies only to the extent the proceeds of those enterprise zone facility bonds are loaned to one or more enterprise zone businesses within 42 months of the issue date of the enterprise zone facility bonds or are used to redeem enterprise zone facility bonds of the issue within that 42-month period. (ii) Pooled financing bond program defined. For purposes of this section, a pooled financing bond program is a program in which the issuer of enterprise zone facility bonds, in order to provide loans to enterprise zone businesses, lends the proceeds of the enterprise zone facility bonds to a bank or similar intermediary (intermediary lender) which must then re lend the proceeds to two or more enterprise zone businesses. (h) Original use requirement for purposes of qualified zone property. In general, for purposes of section 1397C(a)(1)(B), the term original use means the first use to which the property is put within the zone. For purposes of section 1394, if property is vacant for at least a one-year period including the date of zone designation, use prior to that period is disregarded for purposes of determining original use. For this purpose, de minimis incidental uses of property, such as renting the side of a building for a billboard, are disregarded. (i) Land. The determination of whether land is functionally related and subordinate to qualified zone property is made in a manner consistent with the rules for exempt facilities under section 142. (j) Principal user—(1) In general. Except as provided in paragraph (j)(2) of
this section, the term **principal user** means the owner of financed property.

(2) **Rental of real property**—(i) A lessee as the principal user. If an owner of real property financed with enterprise zone facility bonds is not an enterprise zone business within the meaning of section 1397B, but the rental of the property is a qualified business within the meaning of section 1397B(d)(2), the term **principal user** for purposes of sections 1394(b) and (e) means the lessee or lessees.

(ii) **Allocation of enterprise zone facility bonds.** If a lessee is the principal user of real property under paragraph (j)(2)(i) of this section, then proceeds of enterprise zone facility bonds may be allocated to expenditures for real property only to the extent of the property allocable to the lessee’s leased space, including expenditures for common areas.

(3) **Pooled financing bond program.** An intermediary lender in a pooled financing bond program described in paragraph (g)(2) of this section is not treated as the principal user.

(k) **Treatment as separately incorporated business.** For purposes of section 1394(b)(3)(B), a trade or business may be treated as separately incorporated if allocations of income and activities attributable to the business conducted within the zone are made using a reasonable allocation method and if that trade or business has evidence of those allocations sufficient to establish compliance with the requirements of paragraphs (b) through (f) of this section. Whether an allocation method is reasonable will depend upon the facts and circumstances. An allocation method will not be considered to be reasonable unless the allocation method is applied consistently by the trade or business and is consistent with the purposes of section 1394.

(l) **Substantially all.** For purposes of sections 1397B and 1397C(a), the term **substantially all** means 85 percent.

(m) Application of sections 142 and 146 through 150—(1) **In general.** Except as provided in this paragraph (m), enterprise zone facility bonds are treated as exempt facility bonds that are described in section 142(a), and all regulations generally applicable to exempt facility bonds apply to enterprise zone facility bonds. For this purpose, enterprise zone businesses are treated as meeting the public use requirement. Sections 147(c)(1)(A) (relating to limitations on financing the acquisition of land), 147(d) (relating to financing the acquisition of existing property), and 142(b)(2) (relating to limitations on financing office space) do not apply to enterprise zone facility bonds. See also paragraph (n)(4) of this section.

(2) **Maturity limitation—(i) Requirements.** An issue of enterprise zone facility bonds, the proceeds of which are to be used as part of a loan recycling program, satisfies the requirements of section 147(b) if—

(A) Each loan satisfies the requirements of section 147(b) (determined by treating each separate loan as a separate issue); and

(B) The term of the issue does not exceed 30 years.

(ii) **Loan recycling program defined.** A **loan recycling program** is a program in which—

(A) The issuer reasonably expects as of the issue date of the enterprise zone facility bonds that loan repayments from principal users will be used to make additional loans during the zone designation period;

(B) Repayments of principal on loans (including prepayments) received during the zone designation period are used within six months of the date of receipt either to make new loans to enterprise zone businesses or to redeem enterprise zone facility bonds that are part of the issue; and

(C) Repayments of principal on loans (including prepayments) received after the zone designation period are used to redeem enterprise zone facility bonds that are part of the issue within six months of the date of receipt.

(3) **Volume cap.** For purposes of applying section 146(f)(5)(A) (relating to elective carryforward of unused volume limitation), issuing enterprise zone facility bonds is a carryforward purpose.

(4) **Remedial actions.** In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, if a loan fails to meet the requirements of paragraphs (b) through (f) of this section, within six months of
noncompliance (after taking into account the deemed compliance provisions of paragraph (b)(3) of this section, if applicable), an amount equal to the outstanding loan principal must be prepaid and the issuer must—

(i) Reloan the amount of the prepayment or

(ii) Use the prepayment to redeem an amount of outstanding enterprise zone facility bonds equal to the outstanding principal amount of the loan that no longer meets those requirements.

(n) Continuing compliance and change of use penalties—(1) In general. The penalty provisions of section 1394(e) apply throughout the period of compliance required under paragraph (b)(1) of this section.

(2) Coordination with deemed compliance provisions. Section 1394(e)(2) does not apply during any period during which the issue is deemed to comply with the requirements of section 1394 under the deemed compliance provisions of paragraph (b)(3) of this section.

(3) Application to pooled financing bond and loan recycling programs. In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, section 1394(e) applies on a loan-by-loan basis.

(4) Section 159(b)(4) inapplicable. Section 159(b)(4) does not apply to enterprise zone facility bonds.

(o) Refunding bonds—(1) In general. An issue of bonds issued after the zone designation period to refund enterprise zone facility bonds (other than in an advance refunding) are treated as enterprise zone facility bonds if the refunding issue and the prior issue, if treated as a single combined issue, would meet all of the requirements for enterprise zone facility bonds, except the requirements in section 1394(e)(c). For example, the compliance period described in paragraph (b)(1) of this section is calculated taking into account any extension of the weighted average maturity of the refunding issue compared to the remaining weighted average maturity of the prior issue. The proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the prior issue.

(2) Maturity limitation. The maturity limitation of section 147(b) is applied to a refunding issue by taking into account the issuer’s reasonable expectations about the economic life of the financed property as of the issue date of the prior issue and the actual weighted average maturity of the combined refunding issue and prior issue.

(p) Examples. The following examples illustrate paragraphs (a) through (o) of this section:

Example 1. Averaging of enterprise zone business requirements. City C issues enterprise zone facility bonds, the proceeds of which are loaned by C to Corporation B to finance the acquisition of equipment for its existing business located in a zone. On the issue date of the enterprise zone facility bonds, B meets all of the requirements of section 1397B(b), except that only 25% of B’s employees reside in the zone. In each of the first, second, and third taxable years after the initial testing date, 35%, 40% and 45%, respectively, of B’s employees are zone residents. B continues to meet the 35% resident employee requirement, because the average of zone resident employees for those four taxable years is approximately 36%. The percentage of zone residents employed by B before the initial testing date is not included in determining whether B continues to comply with the 35% resident employee requirement.

Example 2. Measurement of resident employee percentage. Authority D issues enterprise zone facility bonds, the proceeds of which are loaned to Sole Proprietor F to establish an accounting business in a zone. In the first year after the initial testing date, the staff working for F includes F, who works 40 hours per week and does not live in the zone, one employee who resides in the zone and works 10 hours per week, one employee who resides in the zone and works 10 hours per week, one employee who does not reside in the zone and works 10 hours per week, one employee who works 40 hours per week, and one employee who does not reside in the zone and works 10 hours per week. F meets the 35% resident employee test by calculating the percentage on the basis of employee actual work hours as described in paragraph (e)(3)(i)(B) of this section. If F uses the per-employee basis as described in paragraph (e)(3)(i)(A) of this section to determine if the resident employee test is met, the percentage of employees who are zone residents on a per-employee basis is only 33% because F must exclude from the numerator and the denominator the employee who works only 10 hours per week. If F calculates
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the resident employee test as a percentage of employee actual work hours as described in paragraph (e)(3)(ii)(B) of this section in the first year, \( P \) must calculate the resident employee test as a percentage of employee actual work hours each year.

\textbf{Example 3. Active conduct of business within the zone.} State \( G \) issues enterprise zone facility bonds. The town of \( J \) loans the proceeds to Corporation \( H \) to finance the acquisition of equipment for \( H \)'s mail order clothing business, which is located in a zone. \( H \) purchases the supplies for its clothing business from suppliers located both within and outside of the zone and expects that orders will be received both from customers who will reside or work within the zone and from others outside the zone. All orders are received and filled at, and are shipped from, \( H \)'s clothing business located in the zone. \( H \) meets the requirement that at least 80% of its gross income is derived from the active conduct of business within the zone.

\textbf{Example 4. Enterprise zone business definition.} City \( J \) issues enterprise zone facility bonds, the proceeds of which are loaned to Partnership \( K \) to finance the acquisition of equipment for its printing operation located in the zone. All orders are taken and completed, and all billing and accounting activities are performed, at the print shop located in the zone. \( K \), on occasion, uses its equipment (including its trucks) and employees to deliver large print jobs to customers who reside outside of the zone. So long as \( K \) is able to establish that its trucks are used in the zone at least 85% of the time and its employees perform at least 85% of services for \( K \) in the zone, \( K \) meets the requirements of sections 1397B(b) (3) and (5).

\textbf{Example 5. Treatment as a separately incorporated business.} The facts are the same as in Example 4 except that six years after the issue date of the enterprise zone facility bonds, \( K \) determines to expand its operations to a second location outside of the boundaries of the zone. Although the expansion would result in the failure of \( K \) to meet the tests of 1397B(b), \( K \), using a reasonable allocation method, allocates income and activities to its operations within the zone and has evidence of these allocations sufficient to establish compliance with the requirements of paragraphs (b) through (i) of this section. The bonds will not fail to be enterprise zone facility bonds merely because of the expansion.

\textbf{Example 6. Treatment of pooled financing bond programs.} Authority \( L \) issues bonds in the aggregate principal amount of $5,000,000 and loan the proceeds to Bank \( M \) pursuant to a loans-to-lenders program. \( M \) does not meet the definition of enterprise zone business contained in section 1397B. Prior to the issue date of the bonds, \( L \) held a public hearing regarding issuance of the bonds for the loans-to-lenders program, describing the projects of identified borrowers to be financed initially with $4,000,000 of the proceeds of the bonds. The applicable elected representative of \( L \) approved issuance of the bonds subsequent to the public hearing. The loan agreement between \( L \) and \( M \) provides that the other proceeds of the bonds will be held by \( M \) and loaned to borrowers that qualify as enterprise zone businesses, following a public hearing and approval by the applicable elected representative of \( L \) of each loan by \( M \) to an enterprise zone business. None of the loans will be in principal amounts in excess of $3,000,000. The loans by \( M \) will otherwise meet the requirements of section 1394. The bonds will be enterprise zone facility bonds.

\textbf{Example 7. Original use requirement for purposes of qualified zone property.} City \( N \) issues enterprise zone facility bonds, the proceeds of which are loaned to Corporation \( P \) to finance the acquisition of equipment. \( P \) uses the proceeds after the zone designation date to purchase used equipment located outside of the zone and places the equipment in service at its location in the zone. Substantially all of the use of the equipment is in the zone and is in the active conduct of a qualified business by \( P \). The equipment is treated as qualified enterprise zone property under section 1397C because \( P \) makes the first use of the property within the zone after the zone designation date.

\textbf{Example 8. Principal user.} State \( R \) issues enterprise zone facility bonds and loans the proceeds to Partnership \( S \) to finance the construction of a small shopping center to be located in a zone. \( S \) is in the business of commercial real estate, \( S \) is not an enterprise zone business, but has secured one anchor lessee, Corporation \( T \), for the shopping center. \( T \) would qualify as an enterprise zone business. \( S \) will derive 60% of its gross rental income of the shopping center from \( T \). \( S \) does not anticipate that the remaining rental income will come from enterprise zone businesses. \( T \) will occupy 60% of the total rentable space in the shopping center. \( S \) can use enterprise zone facility bond proceeds to finance the portion of the costs of the shopping center allocable to \( T \) (60%) because \( T \) is treated as the principal user of the enterprise zone facility bond proceeds.

\textbf{Example 9. Remedial actions.} State \( W \) issues pooled financing enterprise zone facility bonds, the proceeds of which will be loaned to several enterprise zone businesses in the two enterprise communities and one empowerment zone in \( W \). Proceeds of the pooled financing bonds are loaned to Corporation \( X \), an enterprise zone business, for a term of 10 years. Six years after the date of the loan, \( X \) expands its operations beyond the empowerment zone and is no longer able to meet the requirements of section 1394. \( X \) does not reasonably expect to be able to cure the noncompliance. The loan documents provide
that X must prepay its loan in the event of noncompliance. W does not expect to be able to reloan the prepayment by X within six months of noncompliance. X’s noncompliance will not affect the qualification of the pooled financing bonds as enterprise zone facility bonds if W uses the proceeds from the loan prepayment to redeem outstanding enterprise zone facility bonds within six months of noncompliance in an amount comparable to the outstanding amount of the loan immediately prior to prepayment. X will be denied an interest expense deduction for the interest accruing from the first day of the taxable year in which the noncompliance began.

(q) Effective dates—(1) In general. Except as otherwise provided in this section, the provisions of this section apply to all issues issued after July 30, 1996, and subject to section 1394.

(2) Elective retroactive application in whole. An issuer may apply the provisions of this section in whole, but not in part, to any issue that is outstanding on July 30, 1996, and is subject to section 1394.