

connection with the incidental provision of water facilities in an industrial park.

(d) *Examples.* The application of the rules contained in section 103(c)(5) and this section are illustrated by the following examples:

*Example 1.* City A and corporations X, Y, and Z (unrelated companies) enter into an arrangement under which A is to acquire a tract of land suitable for use as an industrial park. The arrangement provides that: (1) A will issue \$10 million of bonds to be used for the acquisition and development of a suitable tract of land; (2) the tract will be controlled and administered by A, pursuant to a comprehensive zoning plan, for the use of a group of enterprises; (3) A will install necessary water, sewer, and drainage facilities on the tract; (4) A will sell substantial portions of the developed tract to X for use as a factory site and to Y for use as a warehouse site; (5) A will lease a sizeable portion of the tract to Z for 20 years as a distribution center site; and (6) the developed tract and the proceeds from the sale or lease of parts of the tract will be the security for the bonds. The bonds are industrial development bonds. Since, however, the proceeds of the issue are to be used for the acquisition and development of a tract of land as the site for an industrial park under section 103(c)(5), section 103(c)(1) does not apply unless the provisions of section 103(c)(7) and § 1.103-11 apply.

*Example 2.* The facts are the same as in example (1) except that \$1 million of the proceeds of the \$10 million issue are to be used for the construction of a factory by corporation W or X. The bonds are industrial development bonds. Under these circumstances, substantially all of the proceeds are treated as used or to be used for the acquisition and development of a tract of land as the site for an industrial park described in section 103(c)(5). Accordingly, section 103(c)(1) does not apply unless the provisions of section 103(c)(7) and § 1.103-11 apply.

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#### **§ 1.103-10 Exemption for certain small issues of industrial development bonds.**

(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.

(b) *Small issue exemption—*(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—

(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

(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.

(2) *\$10 million or less.* (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—

(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

(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 or less.

(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—

(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.

(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 (as defined in section 103(b)(6)(C) and paragraph (e) of this section),

(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

(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.

(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.

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

(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.

(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.

(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.

(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.

(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.

(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.

(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.

(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.

(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.

(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).

(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.

(c) *Refunding or refinancing issue exemption—(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—

(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

(ii) To redeem part or all of a prior exempt small refunding issue.

(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—

(i) To redeem part or all of one or more prior exempt small issues, or

(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.

(d) *Certain prior issues taken into account—*(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.

(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—

(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

(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).

(3) *Rules of application.* The rules of this paragraph shall apply—

(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.

(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.

(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) 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

(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.

(f) *Disqualification of certain small issues.* (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).

(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.

(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 \$3½ 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

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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]

### § 1.103-11 Bonds held by substantial users.

(a) *In general.* Section 103(c) (4), (5), or (6) (relating respectively to interest on bonds to finance certain exempt facilities, interest on bonds to finance industrial parks, and the exemption for certain small issues of industrial development bonds) does not apply, as provided in section 103(c)(7), with respect to any obligation for any period during which such obligation is held either by a person who is a substantial user of the facilities with respect to which the proceeds of such obligation were used or by a related person (within the meaning of section 103(c)(6)(C) and paragraph (e) of § 1.103-10). Therefore, in such a case, interest paid on such an obligation is includable in the gross income of a substantial user (or related person) for any period during which such obligation is held by such user (or related person).

(b) *Substantial user.* In general, a substantial user of a facility includes any nonexempt person who regularly uses a part of such facility in his trade or business. However, unless a facility, or a part thereof, is constructed, reconstructed, or acquired specifically for a nonexempt person or persons, such a nonexempt person shall be considered to be a substantial user of a facility only if (1) the gross revenue derived by such user with respect to such facility is more than 5 percent of the total revenue derived by all users of such facility or (2) the amount of area of the facility occupied by such user is more than 5 percent of the entire usable area of the facility. Under certain facts and circumstances, where a nonexempt person has a contractual or preemptive right to the exclusive use of property or a portion of property, such person may be a substantial user of such property. A substantial user may also be a lessee or sublessee of all or any portion of the facility. A licensee or similar person may also be a substantial user

where his use is regular and is not merely a casual, infrequent, or sporadic use of the facility. Absent special circumstances, individuals who are physically present on or in the facility as employees of a substantial user shall not be deemed to be substantial users.

(c) *Examples.* The application of section 103(c)(7) and this section are illustrated by the following examples:

*Example 1.* Pursuant to an arrangement with corporation X, County A issues \$4 million of its bonds (an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of § 1.103-10) and will use the proceeds to finance construction of a manufacturing facility which is to be leased to X for an annual rental of \$500,000. X subleases space to a restaurant operator at an annual rental of \$25,000 for the operation of a canteen and lunch counter for the convenience of X's employees. The canteen is required to be open at least 5 days each week (except holidays) from 8:30 a.m. to 5 p.m., and the lunch counter must be in operation during the noon hour. The canteen regularly sells cigarettes, candy, and soft drinks, and uses advertising displays and dispensers with product names. The space physically occupied and the amount of revenue derived by the restaurant operator are more than 5 percent of the respective amounts with respect to the entire facility. Both X and the restaurant operator are substantial users. However, absent special circumstances none of X's employees, the employees of the restaurant operator, or the customers or salesmen who regularly visit the premises to do business either with X or the restaurant operator are substantial users. Similarly, the manufacturers, distributors, and dealers of products sold in the canteen ordinarily are not substantial users.

*Example 2.* The facts are the same as in example (1) except that X rents food and beverage vending machines from a local dealer. The machines are regularly serviced by the local dealer under a contract with X. Title to and ownership of the machines are retained by the dealer. The local dealer is not deemed to be a substantial user if the revenue derived by such dealer from, and the space occupied by, such machines do not exceed 5 percent of the respective amounts with respect to the entire facility.

*Example 3.* City B proposes to issue \$2 million of bonds which qualify as an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of § 1.103-10 in order to construct a medical building for certain physicians and dentists. The facility will contain 30 offices to be leased on equal terms