SMALL ISSUE EXEMPT INDUSTRIAL DEVELOPMENT BONDS FOR CLOSE CORPORATIONS AND THEIR SHAREHOLDERS

Corporations incur expenses and make expenditures to generate increased capacity and efficiency. These benefits produce additional revenue. The goal of increasing revenues often requires capital asset expansion, the process of making a present expenditure that generates benefits and resulting revenue over more than one taxable year.[1] Capital assets include property, plant, and equipment. Capital asset expansion is predicated on a source of funds. The close corporation may rely on internal funding through working capital[2] or retained earnings.[3] These sources, however, often fail to satisfy the initial financing requirements of the expansion. Furthermore, certain characteristics of a close corporation—the small number of shareholders, the lack of a secondary market for the sale and purchase of the corporate stock, and the dominance of shareholder participation in management and decision-making—limit the corporation's[4] access to additional equity financ-

1. The corporation records expenditures for capital assets on the debit side of its balance sheet because the assets' utility, *i.e.*, ability to generate revenue, extends beyond one accounting period. The corporation capitalizes these expenditures over the assets' useful life, thereby recognizing the expenditure as an expense. This process allows for a matching of revenue and expense over the useful life of the asset. Note that expenditures for capital assets are distinguished from revenue expenditures, which appear on the income statement as expenses in the current period. Examples of revenue expenditures include supplies, rents, and utilities. Because the useful life of revenue expenditures generally does not exceed the current accounting period, they need not be capitalized. *See* W. MEIGS, A. MOSICH & G. JOHNSON, INTERMEDIATE ACCOUNTING 16-17, 99-100 (4th ed. 1978).

2. Working capital is the excess of current assets over current liabilities. Although the primary source of working capital is revenue from operations, a corporation may generate working capital by selling noncurrent assets, long term debt arrangements, and additional equity contributions. Corporations primarily use working capital, perceived as a measure of the security of short term creditors, to satisfy current liabilities, not long-term investment projects. *See id.* at 143-48. *See also* 3 AICPA PROFESSIONAL STANDARDS—ACCOUNTING § 2031 (1980).

3. The term "retained earnings" represents the net income from prior periods legally available for capital investments.

4. *See* Donahue v. Rodd Electrotype Co., 367 Mass. 578, 585-86, 328 N.E.2d 505, 511 (1975); Darvin v. Belmont Indus., Inc., 40 Mich. App. 672, 677, 199 N.W.2d 542, 544 (1972) (dictum). The *Donahue* court sought to define a close corporation by examining typical characteristics:

> There is no single, generally accepted definition. Some commentators emphasize an "integration of ownership and management" . . . in which the stockholders occupy most management positions. . . . Others focus on the number of stockholders and the nature

ing.[5] Therefore, corporations facilitate the capital asset expansion program by entering into a debt leveraging arrangement involving three parties: the lender-creditor, the corporation-debtor, and the seller of capital assets.

This Note examines the statutorily created small issue exempt industrial development bond[6] as a cost-effective four-party financing arrangement for close corporation capital asset expansion. The four parties to the financing arrangement include the bond holder as lender-secured creditor, the corporation as debtor, the governmental unit as tax exempt conduit, and the seller. The debt leveraging transaction differs from simple three party financing in one respect: The lender in this debt leveraging transaction purchases bonds from the governmental unit which subsequently purchases or constructs the capital assets. The governmental unit enters into a capital lease with the corporation. The rental terms of the lease parallel the bond debt servicing requirements. At the contemporaneous expiration of the capital lease and debt obligation the close corporation may exercise a de minimis option to purchase the capital assets.

Part I of this Note reviews the theory of capital budgeting as a means of analyzing capital asset expansion opportunities, with particular emphasis on the cost of capital and the small issue exempt industrial development bond. Part II explains the characteristics of small issue exempt industrial development bonds, examining the permissible uses of bond proceeds and restrictions on the form of the bond issue. Part

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> of the market for the stock. In this view, close corporations have few stockholders; there is little market for corporate stock.

367 Mass. at 585, 328 N.E.2d at 511.

The smallest close corporation is the one-man corporation. Dean O'Neal distinguishes a close corporation from closed corporations and closely held corporations:

> The terms "close corporation," "closed corporation" and "closely held corporation" are often considered to be synonymous and are used interchangeably. "Closed" perhaps sometimes emphasizes a determination on the part of the participants in the enterprise to keep outsiders from acquiring any interest in the business and perhaps indicates that by shareholders' agreement or charter or bylaw provision they have taken steps to accomplish that objective. "Closely held," on the other hand, seems to focus more on the number of shareholders in the corporation at that particular time, indicating that they are few in number.

1 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 1.04 (2d ed. 1971).

5. *See generally* 1 F. O'NEAL, *supra* note 4, at § 2.08; Howell, *Financing—A Major Problem of Small Business*, 18 VAND. L. REV. 1683 (1965); Lehrman, *The Problems of Small Business Financing*, 1 TEX. SO. INTRA. L. REV. 139 (1970); Note, *Stockholder Loans and the Debt-Equity Distinction*, 22 STAN. L. REV. 847 (1970).

6. *See* I.R.C. § 103(b)(6).

III examines the debt versus equity classification obstacle and the possible forfeiture of the interest income exemption facing shareholders who purchase bonds issued on behalf of their close corporation.

I. CAPITAL BUDGETING AND THE COST OF CAPITAL TO THE CLOSE CORPORATION

Capital budgeting provides a framework for evaluating capital asset investment opportunities.[7] Corporations commonly use the capital budgeting method[8] known as the "net present value" approach.[9] Under this approach the close corporation estimates the projected expenditures for a project and the expected future income stream generated by the project. The projected expenditures and expected future income stream are first discounted to their present value by the market rate of interest and then the values are compared. If the discounted future income stream exceeds the present value of projected expenditures, the project has a positive rate of return and is profitable.[10]

A major expenditure component of debt leveraged capital asset expansion is the cost of borrowed capital. Borrowed capital represents the "source" of funds used to finance the purchase of capital assets. The pretax cost of borrowed capital is the interest rate, which equates

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7. *See generally* M. ABDELSAMAD, A GUIDE TO CAPITAL EXPENDITURE ANALYSIS (1973); J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 105-44 (5th ed. 1980); Abdelsamad & DeGenaro, *What Every Manager Should Know About Capital Budgeting*, SAM ADVANCED MGT. J., Oct. 1974, at 57; Abdelsamad & Hunt, *Capital Expenditure Analysis: Key to Financial Management*, ADM. MGT., Oct. 1973, at 63; Kim, *Making the Long-Term Investment Decision*, MGT. ACCOUNTING, March 1979, at 41.

8. The numerous capital budgeting techniques may be categorized as time value approaches and nontime value approaches. The time value approaches include the net present value approach, the discounted cash flow rate of return, and the average rate of return. The nontime value approaches include the payout period and the accounting rate of return ratios. *See* M. ABDELSAMAD, *supra* note 7; Vernon, *Capital Budgeting and the Evaluation Process*, MGT. ACCOUNTING, Oct. 1972, at 119.

9. *See* M. ABDELSAMAD, *supra* note 7, at 96-124; J. VAN HORNE, *supra* note 7, at 115-16.

10. Algebraically, the net present value (NPV) equation is:

$$NPV = \sum_{t=o}^{n} \frac{A_t}{(1+k)^t} = \frac{A_o}{(1+k)^o} + \frac{A_1}{(1+k)^1} + \ldots \frac{A_n}{(1+k)^n}$$

where A represents the *net* cash flow for each period t including the initial cash outflow for the investment plus the expected cash inflow in future periods, k represents the required rate of return which is assumed to be the cost of capital, and n represents the expected life of the investment. A positive net present value indicates that the investment opportunity is profitable. A zero or negative net present value indicates that the investment is unprofitable.

the value of the amount received by the borrower with the present value of the principal and interest payments made by the borrower in the course of debt servicing.[11] The pretax cost of capital is adjusted downward by the marginal tax rate of the close corporation to reflect the deductibility of interest payments as a trade or business expense.[12]

The small issue exempt industrial development bond, a "source" of funds financing arrangement,[13] takes the form of a capital lease[14] between the governmental unit as lessor and the close corporation as lessee.[15] On its balance sheet, the corporation records the capital lease as an asset and the corresponding debt as a liability. The amount re-

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11. *See* J. VAN HORNE, *supra* note 7, at 226.

12. *Id.* at 229.

13. *See* Rev. Rul. 68-590, 1968-2 C.B. 66, 67-68. Comparing the form and substance of a transaction, the Internal Revenue Service held:

> The substance of a transaction, rather than its legal form, is controlling for Federal income tax purposes. . . . Calling a transaction a lease does not make it one, if in fact it is something else.
>
> The substance of the agreements between the corporation and the political subdivision . . . is clearly that of a financing arrangement.

Id. The Service amplified this holding in Rev. Rul. 72-543, 1972-2 C.B. 87, 88: "Revenue Ruling 68-590 relates to the income tax treatment of certain financial arrangements entered into between a political subdivision of a State and a corporation . . . . [S]uch arrangement is considered merely a financial arrangement." *Id.*

14. The capital lease designation is an accounting definition that includes a "lease [that] transfers ownership of the property to the lessee by the end of the lease term [or a] lease [that] contains a bargain purchase option." 3 AICPA PROFESSIONAL STANDARDS—ACCOUNTING §§ 4053.007(a), (b) (1980). This definition parallels the lease description in Rev. Rul. 68-590, 1968-2 C.B. 66, 67: "[T]he political subdivision and the corporation enter into the 'Lease Agreement and Option to Purchase' . . . for an initial lease term . . . substantially shorter than the useful life of the project. . . . The corporation is also given an option to purchase the project for a nominal amount."

15. Although the close corporation is nominally titled lessee, the capital lease arrangement transfers all of the incidents of ownership to the lessee. The Internal Revenue Service concluded that the bond issue was not an exempt issue for other reasons, but stated that "[u]nder the terms of the lease, *A* may acquire title to the property for a nominal amount upon termination of the lease. *A* will be treated as the owner of the facilities for Federal income tax purposes." Rev. Rul. 77-317, 1977-2 C.B. 32, 33. *See also* Rev. Rul. 75-185, 1975-1 C.B. 43, 43 (corporation considered owner of facilities for federal tax purposes); Rev. Rul. 73-134, 1973-1 C.B. 60, 60 (same).

In Rev. Rul. 68-590 the Service detailed the incidents of ownership that accrue to the lessee:

> (1) The corporation will be considered the purchaser and original user of the project and its component parts;
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> (2) The corporation will be entitled to the investment credit provided under section 38 of the Code with respect to that portion of the project which constitutes "section 38 property," subject to the provisions of sections 46, 47, and 48 of the Code and the regulations thereunder, but in this regard, the exceptions provided in section 48(a)(4) and (5) of the Code will not apply;
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> (3) The corporation will take into account any premium or discount on the bonds pursuant to section 61 of the Code and the regulations thereunder;

corded is the present value of the minimum lease payments for the term of the lease.[16] The minimum lease payments equal the debt servicing principal and interest payments.[17]

A close corporation has, as one of its goals, the maximization of investment opportunities. Under net present value analysis, the projected profitability of capital asset expansion is maximized when the difference between the discounted future income stream and the present value of expenditures is greatest. As the difference decreases, the investment, although still profitable, becomes less attractive. When the discounted future income stream equals the present value of expenditures, an investment has zero profit. The required expenditures thus represent an investment "floor." If the discounted future income stream is below the floor, the investment option has a negative return and is unprofitable. The close corporation endeavors to lower the investment "floor" by minimizing its cost components.

The small issue exempt industrial development bond satisfies this objective. The governmental unit is a financing conduit for the benefit of the lender-bond holder and borrower-close corporation. The interest earned and received by the lender from the bonds is exempt from fed-

> (4) The corporation will not be entitled to rental deductions which are allowed by section 162(a)(3) of the Code and the regulations thereunder;
> (5) The corporation will be entitled to deductions for all ordinary and necessary expenses paid or incurred in the operation of the project, including but not limited to the annual trustee's fees, pursuant to section 162 of the Code and the regulations thereunder;
> (6) The corporation will be entitled to interest deductions with respect to that portion of the basic rentals which represents, in effect, the interest payable on the bonds pursuant to section 163 of the Code and the regulations thereunder;
> (7) The corporation will be entitled to deductions for all state and local taxes imposed with respect to the project, pursuant to section 164 of the Code and the regulations thereunder; and
> (8) The corporation will be entitled to depreciation deductions with respect to all depreciable property in the project, pursuant to section 167 of the Code and the regulations thereunder.

Rev. Rul. 68-590, 1968-2 C.B. 66, 68.

16. *See* 3 AICPA PROFESSIONAL STANDARDS—ACCOUNTING § 4053.010 (1980). If the capital lease includes more than one asset, the lessee must approximate the present value of the minimum lease payments for each asset. *Id.* § 4053.026(a)(1). The lessee depreciates the recorded assets, consistent with its policy of depreciation and amortization, over the useful life of the asset. *Id.* § 4053.011. Additionally, the lessee reduces the value of the obligation per the "interest" method. The result of this method is a constant periodic rate of interest on the liability balance. *Id.* § 4053.012.

17. *See id.* § 4053.010; Rev. Rul. 77-262, 1977-2 C.B. 42. In Rev. Rul. 77-262 the Service stated: "Under the terms of the lease, *X* is required to make rent payments at certain specified times equal to the sum of the principal amount of bonds due and payable at that time plus the interest required to be paid on such date." *Id.* at 42.

eral income taxation.[18] For the corporation, the tax-exempt status of bond interest income to the lender results in a reduction of the interest cost of capital by the marginal tax rate of the lender.[19] The lower cost of capital reduces the present value of the principal and interest expenditure component. A lower cost component in turn lowers the investment floor, increasing both the number of profitable investment opportunities and the profitability of each opportunity.[20]

II. THE SMALL ISSUE EXEMPT INDUSTRIAL DEVELOPMENT BOND

The small issue exempt industrial development bond is a statutorily

18. *See* I.R.C. § 103(a)(1) (excluding from income interest on government obligations). The value of the interest exemption is discussed in dictum in Cohen v. Marine Protein Corp., [1979-1] U.S. Tax Cas. ¶ 9387 at 86,954 (S.D.N.Y.):

> [T]he government came along with these provisions in the tax law to say, we will make the bonds that issue from these communities, these industrial bonds, tax-free so that anybody who buys them and he gets income from the bonds, will really be getting a large return, because as each and everyone of us know, the tax bite on our salaries and other income makes the gross income a good deal smaller than what it appears on the day you receive it.
>
> But here was an opportunity for persons who wanted to take the chance of investing in these industrial bonds to get, in effect, a higher rate of interest by getting tax-free interest.

Id.

19. For example, if the close corporation issues corporate bonds that yield taxable interest to the bondholder, the bondholder's real rate of return must be adjusted downward by the bondholder's marginal tax rate. If the bondholder is in a 50% tax bracket, a bond with a stated interest rate of 12% will provide the bondholder with an after tax return of 6%. A 50% tax bracket investor in small issue exempt industrial development bonds, yielding nontaxable interest income of 6%, has the same rate of return as the investor in 12% taxable bonds. All other factors being equal, the investments are thus equally attractive to the bondholders. They are not, however, equally attractive to the close corporation. In all instances, the close corporation would prefer a cost of capital equal to 6% rather than 12%.

20. For example, the Industrial Development Authority (IDA) of the City of St. Louis, Missouri provides in its promotional literature a case study of Revenue Bond Services. The study compares the reduction in the cost of capital variable. This variable, k, is used in the net present value calculation to determine the profitability of a particular investment project. *See* note 10 *supra*. The cost of capital variable is the primary expenditure component for long-term financing of capital asset expansion. Comparing conventional financing with industrial revenue bond financing illustrates both the absolute and percentage dollar savings from the latter. Certainly, the XYZ Corporation in the hypothetical investment project on the following page would welcome the savings opportunity.

[see Table on following page]

created obligation[21] of limited applicability.[22] Congressionally man-

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Hypothetical Investment Project

XYZ Corporation desires to purchase and rehabilitate an office building.

Costs:	
Land & Building	$ 600,000
Rehabilitation	$ 1,400,000
TOTAL	$ 2,000,000

COMPARISON

Conventional:

Assumes interest rate of 12%, term of 20 years and 100% financing although conventional financing usually requires a minimum 20% down-payment.

Financing:	
Monthly Payments	$ 21,064.60
Annual Payments	$ 252,775.20

IDA Revenue Bonds:

Assumes interest rate of 8%, term of 20 years and 100% financing, although terms of up to 40 years can be obtained through IDA.

Financing:	
Monthly Payments	$ 15,346.40
Annual Payments	$ 185,236.80

IDA Revenue Bond Advantage:

Monthly Savings with IDA (21,064.60 − 15,436.40)	5,628.20
Annual Savings with IDA (252,775.20 − 185,236.80)	67,538.40
Total Savings with IDA (20 yr. term) ($67,538.40 × 20 years)	$1,350,768.00

The total savings of $1,350,768 is the difference between the total conventional financing of $5,055,504 ($252,775.20 × 20 years) and the total revenue bond financing of $3,704,736 ($185,236.80 × 20 years). This savings represents a 27% decrease in total project expenditures.

21. Prior to the passage of section 107 of the Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, § 107, 82 Stat. 25, the Code contained only the language of section 103(a). This Code section stated the general rule that "[g]ross income does not include interest on . . . the obligations of a State . . . or any political subdivision." I.R.C. § 103(a)(1). In turn, the Internal Revenue Service allowed industrial development bonds to flourish in both number and amount. *See* Rev. Rul. 63-20, 1963-1 C.B. 24 (bonds issued on behalf of municipality for purpose of constructing facilities to be leased to private industry are exempt obligations); Rev. Rul. 57-187, 1957-1 C.B. 65 (bonds issued by Industrial Development Board considered issued on behalf of political subdivision); Rev. Rul. 54-106, 1954-1 C.B. 28 (interest paid on bonds issued by municipality to finance construction subsequently leased to private industry exempt from federal income tax). With the 1968 Revenue Act, Pub. L. No. 90-364, 82 Stat. 251, 266, Congress expressly provided in I.R.C. § 103(b)(1) that "[e]xcept as otherwise provided . . . , any industrial development bond shall be treated as an obligation *not* described in [I.R.C. § 103(a)(1)]" (emphasis added). As a

dated limitations affect the range of planning opportunities available to the close corporation. First, the statutory language defines the permissible uses of bond proceeds available to the close corporation. Second, the corporation must comply with restrictions on the bond issue, including maximum denominations and security requirements. Failure to satisfy these requirements results in forfeiture of the interest exemption from taxable income and a consequent increase in the cost of capital.

A. *Permissible Uses of Bond Proceeds*

The events preceding a bond issue provide an appropriate framework for understanding the restrictions placed on the use of bond proceeds. Typically, a close corporation perceives a need for capital asset expansion. With an eye to reducing its cost of capital,[23] the close corporation contacts the local governmental unit to learn about the availability of a small issue exempt industrial development bond. If the parties reach an agreement, the governmental unit issues a bond resolution or takes some other official action evidencing its intent to provide

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result the interest on industrial development bonds is not exempt for federal tax purposes. Only statutorily mandated exceptions are entitled to the benefit of tax exempt interest. The small issue exempt industrial development bond is a specific exemption created by Congress.

The 1968 reform produced numerous articles concerning the costs and benefits of industrial development bonds. *See generally* Hendricks, *Reconsideration of Industrial Development Bond Income Tax Exemption*, 48 OR. L. REV. 168 (1969); McDaniel, *Federal Income Taxation of Industrial Bonds: The Public Interest*, 1 URB. LAW. 157 (1969).

The history of the industrial development bond and the 1968 reform is discussed in McDaniel, *supra*, at 158-61; Mumford, *The Past, Present and Future of Industrial Development Bonds*, 1 URB. LAW. 147, 148-53 (1969); Spiegel, *Financing Private Ventures with Tax-Exempt Bonds: A Developing "Truckhole" in the Tax Law*, 17 STAN. L. REV. 224 (1965); Note, *The Limited Tax-Exempt Status of Interest on Industrial Development Bonds Under Subsection 103(c) of the Internal Revenue Code*, 85 HARV. L. REV. 1649, 1650-52 (1972).

22. *See* I.R.C. § 103(b)(6); Treas. Reg. § 1.103-10 (1972) ("If an issue is an exempt small issue . . . , then under the requirements of section 103(c)(6) and this section the interest paid on the debt obligations is not includable in gross income, . . . even though such obligations are industrial development bonds."). *See generally* Bell & Hinkle, *Guide to Industrial Revenue Bond Financing*, 9 WASHBURN L.J. 372 (1970); Cottonaro, *Industrial Development Bond Tax Treatment—Small Issues*, 48 PA. B.A.Q. 568 (1977); Ritter, *Working with the New Final Regulations on Industrial Development Bonds*, 37 J. TAX. 330 (1972); Ritter, *Federal Income Tax Treatment of Municipal Obligations: Industrial Development Bonds*, 25 TAX LAW. 511 (1972); Roberts, *Industrial Development Bond Financing: Section 103(b) Examined*, 32 U. FLA. L. REV. 1 (1979); Zwick & Lange, *Accounting and Tax Treatment of Industrial Development Bonds*, 7 TAX ADVISOR 388 (1976); Note, *supra* note 21; Note, *Importance of Assessing Business Transactions for Their Impact Upon the Tax-Exempt Status of Industrial Development Bonds*, 30 SYRACUSE L. REV. 705 (1979).

23. *See* notes 18-20 *supra* and accompanying text.

financing for the capital asset expansion program.[24]

Upon issuance, the corporation must use substantially all of the proceeds[25] of the small issue exempt industrial development bonds[26] for the acquisition, construction, or improvement of land[27] or depreciable property.[28] Only an insubstantial amount of the proceeds is available

24. *See* Treas. Reg.§ 1.103-8(a)(5)(iii) (1972). The governmental unit satisfies the requirement for a bond resolution or some other official action by expressing its present intent to issue the bonds. Rev. Rul. 79-320, 1979-2 C.B. 35. A political subdivision may express its present intent to issue the bonds even if the ultimate approval of the project rests with an agency of the state. Rev. Rul. 80-227, 1980-34 I.R.B. 6. If voter approval is necessary, however, *only* voter approval can satisfy the requirement of present intent. Rev. Rul. 78-260, 1978-2 C.B. 99. The official action is relevant to the timing of the capital asset expansion and permissible uses of bond proceeds. *See* notes 38-43 *infra* and accompanying text.

25. The exemption for the small issue exempt industrial development bond requires that "substantially all of the proceeds . . . are to be used (i) for the acquisition, construction, reconstruction, or improvement of land or property . . . subject to the allowance for depreciation, or (ii) to redeem part or all of a prior issue which was issued for purposes described in clause (i) of this clause." I.R.C. § 103(b)(6)(A). The regulations, reiterating the purposes stated in clause (i) of Code § 103(b)(6)(A), specifically exclude "[p]roceeds which are loaned to a borrower for use as working capital or to finance inventory . . . ." Treas. Reg. § 1.103-10(b)(1)(ii) (1972).

26. An industrial development bond is characterized as any obligation satisfying the trade or business test. I.R.C. § 103(b)(2)(A); Treas. Reg. § 1.103-7(b)(3) (1972). All or a major portion of the proceeds of the government obligation must be used in the trade or business of the close corporation. In conjunction with these guidelines the Internal Revenue Service developed specific examples of when the "trade or business" test is met. The examples elaborate the basic fact patterns for industrial development bond arrangements. *See* Treas. Reg. § 1.103-7(c) (1972) examples (1)-(5) for fact patterns paralleling close corporation industrial expansion. The trade or business test is not a major concern to the close corporation planning the bond issue in conjunction with the governmental unit. In the typical small issue exempt industrial development bond issue the sole use of the proceeds is for the trade or business of the close corporation.

27. The close corporation is not limited to the acquisition of "land" in its common parlance. In Rev. Rul. 80-100 corporation X used $150,000 of a $1,000,000 bond issue to acquire a perpetual easement providing better access to a manufacturing plant financed by the remainder of the issue. Under local law the perpetual easement constituted an interest in real property. The Service held that the perpetual easement constituted an acquisition of land within the provisions of the Code. As a result, 100% of the proceeds were used for the acquisition of land and construction of depreciable property. Rev. Rul. 80-100, 1980-1 C.B. 25.

28. Under section 263(a)(1) of the Internal Revenue Code, "[n]o deduction shall be allowed for . . . [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property . . . ." *Id.* The close corporation "shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . of property used in the trade or business . . . ." I.R.C. § 167(a)(1). An example of depreciable property, other than a building, is manufacturing equipment. 144 IRS LTR. RUL. REP. (CCH) No. 7948110 (Aug. 31, 1979). But the purchase of good will in the context of purchasing the assets of an existing business is not an allowable asset. Rev. Rul. 81-56, 1981-8 I.R.B. 7. Additionally, costs associated with the purchase of capital assets may qualify as property subject to the allowance for depreciation. Any costs included as part of the basis of the capital asset are proper expenditures of bond proceeds. *See* Rev. Rul. 80-356, 1980-52 I.R.B. 7. This includes transportation costs associ-

to provide the close corporation with working capital. In addition, the corporation must locate the assets in or substantially connect them with the governmental unit that issues the bonds.[29] If immovable assets are outside the geographic boundaries, but contiguous with the governmental unit or integrated with existing facilities located within the governmental unit, the Service considers assets substantially connected with the governmental unit.[30] Movable capital assets that operate outside the geographic boundaries of the issuer do not qualify as proper subject matter for the use of bond proceeds.[31]

The "substantially all" requirement means that the governmental unit must spend ninety percent of the amount of bond proceeds on the acquisition, construction, or improvement[32] of land or depreciable

ated with the purchase of capital assets but not transportation costs associated with the relocation of existing capital assets to a new facility financed through bond proceeds. *Id.*; Rev. Rul. 79-135, 1979-1 C.B. 78. Although the cost of transporting existing capital assets does not qualify as an expenditure, any costs associated with modifying and installing the equipment do qualify. Rev. Rul. 79-135, 1979-1 C.B. 78, 79.

29. In Rev. Rul. 77-281 the Service stated two preconditions for the small issue exempt industrial development bond:

> (1) the location of facilities to be financed with [an exempt] small issue must be established within an incorporated municipality or within a county, and (2) the facility financed by the bonds must be located within the boundaries of the issuer (or within the boundaries of the political subdivision in which the issuer is located). A facility will be regarded as being located within the boundaries of the issuer . . . if it has a substantial connection therein.

Rev. Rul. 77-281, 1977-2 C.B. 31. An example of a substantial connection is tractor-trailers and other automotive equipment based in the same city as the bond financed facilities. *See* Treas. Reg. § 1.103-10(f) (1972) example 11. *But see* note 28 *supra*.

30. Treas. Reg. § 1.103-10(b)(2)(ii)(e) (1972) provides that "capital expenditures made with respect to a contiguous or integrated facility which is located on both sides of a border between . . . political jurisdictions are made with respect to a facility located in all such jurisdictions and . . . shall be treated as if they were made in each . . . jurisdiction." *Id.* The Service set a one-half mile distance as the outer boundary between two integrated facilities. Rev. Rul. 76-427, 1976-2 C.B. 28. "The Revenue Ruling, in effect, restricts the application of those provisions of the regulations to structures located on opposite sides of a jurisdictional border which reasonably can be considered to comprise one facility." 130 IRS LTR. RUL. REP. (CCH) No. 7934061 (May 23, 1979). Rev. Rul. 76-427, 1976-2 C.B. 28 held a yarn manufacturing operation integrated with a rug weaving plant one-half mile away, but letter ruling No. 7934061 refused to hold that a chicken feed mill and an office building more than one-half mile away were integrated. 130 IRS LTR. RUL. REP. (CCH) No. 7934061 (May 23, 1979).

31. *See* Rev. Rul. 80-12, 1980-1 C.B. 23 (bond proceeds used to purchase tractors and trailers *not* based in the municipality will not qualify as an exempt small issue); Rev. Rul. 77-281, 1977-2 C.B. 31 (proposed bonds not exempt small issue because railroad cars lack permanent location and substantial contact with proposed issuer).

32. "Whether substantially all of the proceeds of an issue of governmental obligations are used in [a proper] manner is determined consistently with the rules for exempt facilities in § 1.103-8(a)(1)(i)." Treas. Reg. § 1.103-10(b)(1)(ii) (1972). "Substantially all of the proceeds of an issue of

property for the benefit of the close corporation. The corporation is thus unable to use more than ten percent of the proceeds for working capital.[33] The numerator for the "substantially all" calculation consists of amounts the governmental unit actually expended on behalf of the close corporation for the acquisition, construction or improvement of land or depreciable property.[34] The denominator is the net bond proceeds. The net bond proceeds are equal to the bond proceeds received from bond subscribers reduced by neutral costs.[35] Neutral costs include start-up costs such as bond election costs, costs of publishing notices, attorneys' fees, printing costs, trustees' fees for fiscal agents, costs of administering the debt issuance, and similar expenses.[36] Additionally, the debt service cost of fund construction period interest and a debt service reserve incurred subsequent to the bond issuance qualify as neutral costs.[37]

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governmental obligations are used [for an allowed purpose] if 90 percent or more of such proceeds are so used." Treas. Reg. § 1.103-8(a)(1)(i) (1972). *See* Rev. Proc. 79-5, 1979-1 C.B. 485.

33. *See* Rev. Proc. 79-5, 1979-1 C.B. 485.

34. The Service looks to amounts actually expended rather than intended or projected expenditures. Amounts not expended for the proper purposes must serve to redeem the outstanding bond issue.

> The remaining unexpended bond proceeds must have been used to redeem the largest portion of the outstanding bond issue, callable under the terms of the bond indenture, that did not exceed the amount of such unexpended bond proceeds. Any unexpended bond proceeds not used to redeem outstanding bonds because the amount of the callable bonds was less than the unexpended bond proceeds, must be placed in escrow for redemption of outstanding bonds at the earliest possible call date. If all of the bonds were callable at a future date, or were callable only in an amount in excess of the unexpended bond proceeds, all of the unexpended bond proceeds must have been placed in escrow until the entire bond issue is called or the maturity date of the bonds is reached. The amount placed in escrow may not be invested to produce a yield greater than the yield on the bonds.

Rev. Proc. 79-5, 1979-2 C.B. 485. Frequently, the corporation must place a percentage of the proceeds of a bond issue into a debt service reserve fund in the event of the corporation's default. This amount is treated as a neutral cost. *See* notes 35-37 *infra* and accompanying text. Proceeds retained in the reserve fund do not constitute unexpended proceeds addressed in Rev. Proc. 79-5. *See* 151 IRS LTR. RUL. REP. (CCH) No. 8002042 (Oct. 18, 1979). The amount will be included in the numerator of the calculation, but not in the denominator, thereby increasing the likelihood of satisfying the "substantially all" test.

35. "In determining whether the qualified costs of a project have remained within the 90 per cent test, there must first be deducted from the gross proceeds of a bond issue certain euphemistically styled neutral costs to arrive at the base from which the 90 per cent is calculated." Cohen v. Marine Protein Corp., [1979-1] U.S. Tax Cas. ¶ 9387 at 86,953 (S.D.N.Y.).

36. *See* Treas. Reg. § 1.103-8(a)(6) (1972); Cohen v. Marine Protein Corp., [1979-1] U.S. Tax Cas. ¶ 9387 (S.D.N.Y.).

37. *See* Cohen v. Marine Protein Corp., [1979-1] U.S. Tax Cas. ¶ 9387 (S.D.N.Y.); Rev. Rul. 80-171, 1980-27 I.R.B. 7; 192 IRS LTR. RUL. REP. (CCH) No. 8043135 (Aug. 4, 1980); 151 IRS LTR. RUL. REP. (CCH) No. 8002042 (Oct. 18, 1979).

Exigencies requiring immediate capital asset expansion may not allow the close corporation to delay the financing of construction and acquisition of facilities or the use of the facilities until after the issuance of the obligations. The Internal Revenue Service promulgated restrictive regulations that limit the close corporation's ability to commence financing and use of the facilities prior to the date of the bond issue.[38] These regulations provide that the use of bond proceeds to redeem short-term interim financing secured for the construction[39] or acquisition of facilities,[40] or substantial use[41] of an existing facility, prior to the

38. *See* Treas. Reg. § 1.103-8(a)(5) (1972). "The general purpose of [the] section . . . is to prevent the proceeds of an issue of obligations . . . from being used to refinance a facility. Such refinancing would result in providing the owner or user of the facility with working capital rather than providing the facility as required . . . ." Rev. Rul. 79-321, 1979-2 C.B. 37, 37. *See also* 192 IRS LTR. RUL. REP. (CCH) No. 8043078 (July 29, 1980); 165 IRS LTR. RUL. REP. (CCH) No. 8016016 (Jan. 22, 1980).

39. A definition for the commencement of construction is found in letter ruling No. 8015125: " '[C]ommencement of construction' means when actual physical work on the facility is begun as distinguished from preliminary work such as clearing the site, preparing engineering drawings, general grading of the site or ordering of raw materials. In addition, work of a significant nature on a major component must begin" although it need not be significantly completed before the bond resolution. 164 IRS LTR. RUL. REP. (CCH) No. 8015124 (Jan. 18, 1980). As an escape device the private letter rule appears to recognize the divisibility of a capital asset expansion program. Therefore, if construction exists before the bond resolution but the proceeds of the bond issue will not be used to reimburse the prior costs of construction the bonds will qualify for the small issue exemption.

40. *See* Rev. Rul. 80-10, 1980-1 C.B. 21 (one-third of bond proceeds to be used for retirement of interim lien incurred prior to bond resolution; therefore, substantial amount used for working capital); Rev. Rul. 77-317, 1977-2 C.B. 32 (provides examples of excessive interim financing prior to bond resolution); 199 IRS LTR. RUL. REP. (CCH) No. 8050016 (Sept. 16, 1980) (bond resolution and issue subsequent to short-term interim financing considered use of working capital); 105 IRS LTR. RUL. REP. (CCH) No. 7909018 (Nov. 28, 1978) (bond proceeds used to retire debt from previous acquisition considered a use for working capital). Apparently, a bond resolution, once adopted, can be forfeited. In 130 IRS LTR. RUL. REP. (CCH) No. 7934039 (May 23, 1979) a political unit passed a resolution approving the issuance of the bonds. The company in reliance upon the resolution obtained interim financing to secure allowable assets. Due to unforeseen circumstances, the political unit was unable to act upon the resolution. Eighteen months after the initial resolution a second resolution was authorized and the bonds were issued. Although the letter ruling did not address the question, the fact that the bonds were issued outside of the one year period established in the "official action" regulation, Treas. Reg. § 1.103-8(a)(5)(v) (1972), rendered the interest income taxable.

41. The Service takes the position that the acquisition of land is sufficient to qualify as the use of the land. In Rev. Rul. 77-292, 1977-2 C.B. 36, the Service stated that "the original use of the land commenced prior to the date of issue of the obligations by [the political unit] since [the company] acquired the land" prior to an inducement letter or other official action. If the ruling is correct, the purchase of land by a close corporation prior to an inducement letter will necessarily disqualify the bond exemption if the amounts of proceeds expended to redeem private debt obligations exceed 10% of the total bond proceeds adjusted for neutral costs. The purchase of the land

adoption of a bond resolution or some other official action constitutes the prohibited use of proceeds for working capital. Provided that use of the facilities does not commence until the date of the bond issue, the close corporation may use the proceeds to retire short-term interim financing secured subsequent to the bond resolution.[42] If the use of the facilities occurs after the bond resolution but before the issuance of the bonds the corporation may use the bond proceeds to retire interim

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is distinguishable from the making of deposits on an executory contract to purchase. *See* 202 IRS LTR. RUL. REP. (CCH) No. 8052039 (Sept. 30, 1980). In 197 IRS LTR. RUL. REP. (CCH) No. 8048024 (Sept. 2, 1980) deposits were made prior to the bond resolution. Closing on the property did not occur until after the resolution. Prior to the resolution "the Company did not have possession of the land, or any of the burdens and benefits of ownership of the land. . . . The deposits were used to offset the total purchase price and are part of the cost of the acquisition of the land . . . ." *Id.* In 48 IRS LTR. RUL. REP. (CCH) No. 7805049 (Nov. 7, 1977), however, the Service, in dicta, indicated that testing of equipment purchased with a private letter of credit violated the prior use rule. Because the equipment was ordered before the letter of inducement, it may be that the "official" action exception had been violated.

There is the additional question of whether a company's month-to-month lease of an existing facility prior to an inducement letter or other official action is an impermissible substantial use. The prior use disqualification applies when "the original use of a facility commences prior to the date of issue of the obligations issued to [acquire] such facility . . . ." Treas. Reg. § 1.103-8(a)(5)(iv) (1972). The restriction states:

> [If] a *substantial user* . . . of such facility at any time during the 5-year period preceding the date of the issue of [the] obligations . . . receives, directly or indirectly, proceeds of the issue of obligations in question in an amount equal to 5 percent or more of the face amount of the issue [and] will be a *substantial user* of such facility at any time during the 5-year period following [the] date of issue [then the tax-exemption for the interest income on the small issue bond will be forfeited].

Id. (emphasis added). The lessee will receive 100% of the bond proceeds. Whether the lessee can finance the purchase through and retain the benefits of the small issue exempt industrial development bonds thus will depend upon whether the lessee is considered a substantial user.

The regulations state that:

> In general, a substantial user of a facility includes any . . . 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 . . . person . . . such . . . 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.

Treas. Reg. § 1.103-11(b) (1972). The lessee will be a substantial user under both criteria. Bond proceeds will be used to acquire the facility for the lessee. Additionally, the lessee will derive in excess of five percent of the gross revenue of the facility and will occupy in excess of five percent of the usable area of the facility during the term of the month-to-month lease.

42. *See* Treas. Reg. § 1.103-8(a)(5)(iii) (1972). In 65 IRS LTR. RUL. REP. (CCH) No. 7821027 (Feb. 21, 1978) a bank provided interim financing subsequent to issuance of the bond resolution letter. There is no indication that the bonds were issued within one year of the resolution. Based upon the representations, the "substantially all" test was satisfied and the interest income was exempt from taxation.

financing so long as the bonds issue within one year after the later of the acquisition or use of the facilities.[43]

B. *Restrictions on the Form of the Bond Issue*

There are restrictions on the form of the small issue exempt industrial development bond, including restrictions on the types of security provided to bond issue subscribers and the aggregate authorized face amount of the bond issue. The "security interest" test requires that the bond indenture or underlying arrangement between the governmental unit and the close corporation provide security for the payment of principal and interest.[44] The security need not be the assets acquired with the bond proceeds.[45] Any arrangement for payment of principal and interest approximately equal to the present value of debt servicing on the bond issue is satisfactory.[46] If the corporation does not pledge the assets acquired with bond proceeds as security, the Service must know with reasonable certainty the identity of the user of the facilities, if different from the acquiring corporation, before concluding that the parties made the requisite arrangement for payment.[47] Although the promise of the governmental unit alone is insufficient security for the test, the governmental unit's assumption of a secondary role for providing security to bond holders will not cause the debt obligation to fail the "security interest" test.[48]

The permissible aggregate authorized face amounts for small issue

43. *See* Treas. Reg. § 1.103-8(a)(5)(v) (1972). *See also* note 40 *supra*.

44. *See* I.R.C. § 103(b)(2)(B); Treas. Reg. § 1.103-7(b)(4) (1972).

45. *See* Treas. Reg. § 1.103-7(b)(4) (1972), which states:

> The property which is the security for, or the source of, the payment of either the principal or interest on a debt obligation need not be property acquired with bond proceeds. The security interest test is satisfied if, for example, a debt obligation is secured by unimproved land or investment securities used, directly or indirectly, in any trade or business carried on by any private business user.

Id. See also id. at example 14.

46. *See* Rev. Rul. 80-339, 1980-50 I.R.B. 1 (revenue from toll bridge pledged as security for payments of bonds issued to construct airport facilities approximated present value of debt servicing); Rev. Rul. 80-251, 1980-37 I.R.B. 5 (mortgages on facilities financed through bond proceeds sufficient security for payment of principal and interest).

47. The flexible position regarding the security requirement is premised on the belief that the substance rather than the form of the transaction controls. An alternative source of security "frees up" the revenue derived from the assets acquired with bond proceeds. Therefore, the close corporation's ability to service the debt, not the specific assets pledged, is the primary concern of the Service. *See* Rev. Rul. 80-339, 1980-50 I.R.B. 7.

48. *See* Treas. Reg. § 1.103-7(b)(4) (1972).

exempt industrial development bonds are $1,000,000 and $10,000,000.[49] For both classes the aggregate authorized face amount includes not only the face amount of the current issue but also the face amount of certain prior bond issues.[50] Furthermore, the Code provision governing the $10,000,000 class requires the addition of certain nonbond capital expenditures to the aggregate authorized amount.[51] These aggregation requirements may limit the corporation's opportunities to use small issue exempt industrial development bonds for capital asset expansion. The aggregation requirements have two effects: they limit both the size of particular bond issues and the amount of capital expenditures from bond and nonbond proceeds. Failure to satisfy the aggregation requirement results in the loss of the tax exemption for interest earned.

For both classes, the face amount of all prior outstanding small issue exempt industrial development bond issues must be aggregated with the face amount of the current issue if the facilities are located in the same incorporated municipality or unincorporated area of the same county and the principal users of the facilities are the same or related persons.[52]

The location requirement limits the dollar amount of bond financed capital asset expansion by the close corporation in a particular geographic area. This restriction does not prohibit using the bonds in other locations provided the geographic areas are not contiguous[53] or the facilities are not integrated.[54] Facilities are integrated if they are

49. *See* I.R.C. §§ 103(b)(6)(A), (D); Treas. Reg. § 1.103-10 (1972). The Service has not updated the regulations to reflect the increase of the denomination from $5,000,000 to $10,000,000. *See* Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2839 (codified at 26 U.S.C. § 103(b)(6)(A) (Supp. III 1979)).

50. *See* I.R.C. § 103(b)(6)(B).

51. *See* I.R.C. § 103(b)(6)(D)(ii).

52. *See* I.R.C. § 103(b)(6)(B)(i)-(iii), (C).

53. *See* Rev. Rul. 75-193, 1975-1 C.B. 44 (plants of company X and company Y located 300 feet apart on contiguous tracts of land without integrated business purpose or personnel below top management, must be aggregated as related persons). *But see* Rev. Rul. 75-333, 1975-2 C.B. 40 (noncontiguous facilities constructed within county need not be aggregated when one city located within county annexes land on which one facility located, even though only purpose for annexation is avoidance of aggregation). An example of use in noncontiguous areas of nonintegrated facilities is national franchise organizations that establish franchise facilities through the repeated use of small issue exempt industrial development bond financing. *See* Hertzberg, *Use of Tax-Exempt Financing for Stores and Other Business Soars, Stirring Critics*, Wall St. J., Oct. 8, 1980, at 46.

54. *See* note 30 *supra*.

dependent upon each other as part of a manufacturing process[55] and are located in the same proximity.[56]

Although the Code and regulations do not define "principal user," the Service has interpreted the title to include any person who uses more than ten percent of the facility.[57] The percentage use is based upon the rental value paid by the user.[58] A person is a related person to a principal user if the person owns, directly or indirectly, more than a fifty percent interest in the other.[59]

The nonbond capital expenditure aggregation requirement applies to first time users if the corporation elects to come under the provisions of the $10,000,000 small issue exempt industrial development bond.[60]

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55. *See* Rev. Rul. 76-427, 1976-2 C.B. 29 (yarn manufacturing operation integrated with a rug weaving plant); 178 IRS LTR. RUL. REP. (CCH) No. 8029085 (Apr. 24, 1980) (two facilities equipped to operate independently not integrated even though one facility designated as headquarters).

56. *See* Rev. Rul. 76-427, 1976-2 C.B. 29 (same proximity limited to one-half mile); 194 IRS LTR. RUL. REP. (CCH) No. 8045064 (Aug. 15, 1980) (facilities five miles apart do not trigger integration); 191 IRS LTR. RUL. REP. (CCH) No. 8042127 (July 25, 1980) (facilities eight miles apart not integrated); 74 IRS LTR. RUL. REP. (CCH) No. 7830160 (Apr. 29, 1978) (four miles apart, no integration); 37 IRS LTR. RUL. REP. (CCH) No. 7746015 (Aug. 17, 1977) (eight miles apart, no integration).

57. *See* 160 IRS LTR. RUL. REP. (CCH) No. 8011062 (Dec. 20, 1979):

> The term "principal user" of a facility, as used in section 103(b)(6) of the Code, is not defined in any section of the Code or regulations. The example contained in section 1.103-8(a)(6) of the regulations, however, illustrates that the term "substantially all," as used in section 103(b)(4), means 90 percent or more of the proceeds of an industrial development obligation. Impliedly, an "insubstantial" amount of the proceeds of an industrial development obligation would be less than 10 percent of such proceeds. Accordingly, the use of more than 10 percent of the proceeds of an industrial development obligation would disqualify the obligation under section 103(b)(4). By analogy, we have determined that the term "principal user" means use of more than 10 percent of the section 103(b)(6)(D) facility measured by the value paid by such user for that portion of the facility. Thus, in situations where property financed through a "small issue" such as space in a shopping center, is leased, the principal users of such facility would include the lessor and those lessees who rent more than 10 percent, by value, of such facility.

Id. See also 184 IRS LTR. RUL. REP. (CCH) No. 8034157 (June 2, 1980) (sublessee using less than 10% of facility not a principal user); 147 IRS LTR. RUL. REP. (CCH) No. 7951067 (Sept. 20, 1979) (company is a principal user but not the developer).

58. *See* note 57 *supra*.

59. *See* notes 123-26 *infra* and accompanying text. *See also* 157 IRS LTR. RUL. REP. (CCH) No. 8008163 (Nov. 30, 1979) (corporation as one-third shareholder in partnership will not be a related person to a principal user).

60. The first time user is susceptible to aggregation under the $10,000,000 issue because nonbond issue capital expenditures are being aggregated. A first time user may have nonbond capital costs in addition to the capital costs satisfied with bond proceeds. *See generally* Wade, *Industrial Development Bonds—The Capital Expenditure Rule for $10,000,000 Small Issues*, 34 BUS. LAW. 1771 (1979).

This "capital expenditure" rule applies to any issue greater than $1,000,000 but not exceeding the statutory ceiling of $10,000,000.[61] In addition to aggregating prior bond issues, the close corporation must aggregate all nonbond capital expenditures "paid or incurred during the six year period beginning three years before the date of the issue and ending three years after such date."[62] This requirement applies only to nonbond capital expenditures for facilities or other capital assets located in the same incorporated municipality or unincorporated area of the same county whose principal user is the same or a related person.[63]

Capital expenditures include all expenditures chargeable to the corporation's capital account regardless of any provision in the Code permitting current expense treatment.[64] Expenditures for equipment, buildings, or permanent improvements that increase the value of property must be aggregated.[65] Although placing a purchase order for a

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61. *See* I.R.C. § 103(b)(6)(D).

62. I.R.C. § 103(b)(6)(D)(ii).

63. *See* notes 29-30 *supra* and accompanying text for a review of the geographic boundary rules and the exception for contiguous or integrated facilities. *See also* 194 IRS LTR. RUL. REP. (CCH) No. 8045064 (Aug. 15, 1980) (aggregation of nonbond capital expenditures not required for facilities more than one-half mile from bond financed facilities); 191 IRS LTR. RUL. REP. (CCH) No. 8042127 (July 25, 1980) (because straight line distance between facilities is eight miles, no aggregation required). *See also* I.R.C. § 103(b)(6)(E); Rev. Rul. 75-411, 1975-2 C.B. 41. In Rev. Rul. 75-411 the Service stated:

> [T]he acquisition of the Y stock by X will not be a capital expenditure for purposes of determining if the exempt small issue limitation of . . . the Code has been exceeded. However, X and Y will be treated as related persons . . . and capital expenditures made by X and Y during the 6-year period beginning 3 years before the date of issue of the bonds and ending 3 years after such date must be considered for purposes of determining if the [$10,000,000] limitation has been exceeded.

Id. at 42.

64. *See* Treas. Reg. § 1.103-10(b)(2)(ii)(e) (1972). In Rev. Rul. 77-224, 1977-1 C.B. 25, a plastics manufacturer had a cost system that charged clients a separate charge for mold equipment. The molds became the property of the client. Subsequently, the manufacturer changed the pricing system and retained title to the molds. Regardless of the method of charging customers or accounting treatment of the molds, for purposes of industrial development bonds, the assets are capital assets and must be aggregated.

65. I.R.C. § 263(a)(1) states, "[n]o deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." *See* Rev. Rul. 75-147, 1975-1 C.B. 42 (excess capital expenditures attributable to the installation of air conditioning must be capitalized). Furthermore, Rev. Rul. 75-208 states, "neither section 103(c)(6)(D)(ii) of the Code nor section 1.103-10(b)(2)(ii) of the regulations provides for a reduction of the total amount of such section 103(c)(6)(D) capital expenditures by the amount received from the subsequent sale of the capital items." Rev. Rul. 75-208, 1975-1 C.B. 46, 47. *But cf.* Rev. Rul. 77-353, 1977-2 C.B. 44, 44 (long term lease of land is not a capital expenditure item).

capital asset does not trigger inclusion, the close corporation must include the purchase price amount, based on the percentage of completion, for items under construction during the three year period.[66] Expenditures that at the election of the close corporation may be capitalized must be treated as capital expenditures for the capital expenditure rule. Included are expenditures for development of mines,[67] research and experimentation,[68] soil and water conservation,[69] removal of architectural and transportation barriers to the handicapped and elderly,[70] interest, taxes, and other carrying charges of the property.[71] Additionally, the acquisition of a controlling stock interest in another corporation and its subsequent liquidation is considered a purchase of the underlying assets.[72] To the extent capital assets of the newly acquired company are located in the incorporated municipality or unincorporated area of the same county of the acquiring corporation they must be aggregated.[73]

66. The percentage of completion method of accounting requires that capital expenditures during the six year period for work-in-process be aggregated to the extent of the percentage of work completed by the manufacturer or contractor multiplied by the purchase price of the equipment or construction. *See* Rev. Rul. 78-347, 1978-2 C.B. 101; Rev. Rul. 74-485, 1974-2 C.B. 32.

67. *See* I.R.C. § 616.

68. *See* I.R.C. § 174. *See also* Rev. Rul. 77-27, 1977-1 C.B. 23, 24 (research and development costs, expensed for tax accounting purposes, capitalized for purposes of capital expenditure rule). *But see* Rev. Rul. 77-253, 1977-2 C.B. 40 (research and experimentation costs of parent inapplicable to subsidiaries' facilities unless results of the research will be used at the facilities; research and development costs otherwise allocated to place of use); 202 IRS LTR. RUL. REP. (CCH) No. 8052071 (Sept. 30, 1980) (same).

69. *See* I.R.C. § 175.

70. *See* I.R.C. § 190.

71. *See* Rev. Rul. 75-185, 1975-1 C.B. 43, 44 (interest costs, expensed for tax accounting purposes, capitalized for purposes of capital expenditure rule). *See also* Rev. Rul. 81-23, 1981-4 I.R.B. 8 (interest on bond proceeds escrowed for payment to bondholders qualified expenditure as of bond issue since proceeds are committed to qualified assets at time of issue); Rev. Rul. 77-262, 1977-2 C.B. 42 (capital expenditures include gross interest payments until the time of installation of equipment or use of property and real estate taxes); Rev. Rul. 77-234, 1977-2 C.B. 39 (holding underwriting fees, legal fees, recording fees, taxes, and printing costs capital expenditures that must be aggregated).

72. *See* 152 IRS LTR. RUL. REP. (CCH) No. 8003074 (Oct. 25, 1979) (cash purchase of stock and subsequent liquidation under § 332 of Code considered one transaction; basis of assets under § 334(b)(2) equal to acquiring company cost); 112 IRS LTR. RUL. REP. (CCH) No. 7916021 (Jan. 16, 1979) (same). *But see* Rev. Rul. 75-411, 1975-2 C.B. 41 (acquisition of stock in a 'B' reorganization not considered in substance a purchase of assets; basis of assets equal to basis in hands of acquired company); 204 IRS LTR. RUL. REP. (CCH) No. 8103031 (Oct. 21, 1980) (same); 203 IRS LTR. RUL. REP. (CCH) No. 8101074 (Oct. 10, 1980) (purchase of stock without subsequent liquidation not capital expenditure).

73. The formula for calculating the amount aggregated for stock acquisition and liquidation

There are statutory and nonstatutory exceptions to the capital expenditure rule. A capital expenditure is statutorily exempt from the capital expenditure rule if it replaces damaged or destroyed property,[74] is required by a change in federal or state law,[75] or is required by a mistake of law or fact and does not exceed $1,000,000.[76] Nonstatutory exceptions include equipment leasing costs incurred in the ordinary course of business[77] and type "B" stock-for-stock reorganizations not resulting in the liquidation of the acquired company.[78]

Although the small issue exempt industrial development bond provides the close corporation with a reduced cost of capital, there are numerous problems with its use. These obstacles should not discourage the financial planner, however, because careful planning will reward close corporations with a lower cost of capital, thereby increasing the number of profitable capital asset expansion opportunities and the profitability of each opportunity.

III. SHAREHOLDERS' SUBSCRIPTIONS TO SMALL ISSUE EXEMPT INDUSTRIAL DEVELOPMENT BONDS

Bond issue placement is the arm's length process of securing a credi-

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transactions is the total purchase price times the percentage equal to the value of the capital assets located in the municipality compared with the total value of capital assets. *See* 142 IRS LTR. RUL. REP. (CCH) No. 7946049 (Aug. 17, 1979); 135 IRS LTR. RUL. REP. (CCH) No. 7939033 (June 26, 1979). *See also* Rev. Rul. 81-56, 1981-8 I.R.B. 7 (purchase of goodwill in conjunction with tangible assets constitutes a capital expenditure for the aggregation requirement); Rev. Rul. 81-55, 1981-8 I.R.B. 7 (purchase of covenant not to compete in addition to other assets is a capital expenditure for capital expenditure rule); 203 IRS LTR. RUL. REP. (CCH) No. 8101074 (Oct. 10, 1980) (purchase of covenant not to compete capital expenditure); 164 IRS LTR. RUL. REP. (CCH) No. 8015024 (Jan. 18, 1980) (foreign license agreements and foreign patents need not be aggregated).

74. *See* I.R.C. § 103(b)(6)(F)(i). *See also* Rev. Rul. 75-147, 1975-1 C.B. 41, 43:

> Since the excess capital expenditures required due to landscaping to correct erosion, the change in the type of boiler, the change in the architectural design and an increase in engineering fees could not reasonably have been foreseen on the date of the issue of the bonds, such expenditures are excluded expenditures within the meaning of section 1.103-10(6)(2)(iv)(e).

75. *See* I.R.C. § 103(b)(6)(F)(ii).

76. *See* I.R.C. § 103(b)(6)(F)(iii).

77. *See* Rev. Rul. 80-162, 1980-1 C.B. 26 (downpayment on equipment not an acquisition; subsequent decision to lease equipment in bona fide transaction not a capital expenditure). *See also* 166 IRS LTR. RUL. REP. (CCH) No. 8017062 (Jan. 30, 1980); 121 IRS LTR. RUL. REP. (CCH) No. 7925082 (March 22, 1979). *But see* Rev. Rul. 79-248, 1979-2 C.B. 41 (acquisition of equipment and then subsequent sale of equipment with a lease back arrangement, not a bona fide lease transaction; acquisition therefore a capital expenditure).

78. *See* note 72 *supra*.

tor for the four party transaction. Although any individual or business association may purchase small issue exempt industrial development bonds, some purchasers are ineligible to receive the tax exempt interest income benefit that the bond provides. Close corporation shareholders who intend to subscribe to the debt issue must guard against two statutory obstacles: reclassification of the debt subscription as a contribution to equity and loss of tax exempt status on interest income received.

A. *Debt versus Equity Classification*

The "debt-equity imbroglio"[79] results from disparate corporate tax treatment favoring debt rather than equity for capital contributions[80] and the broad latitude given close corporations to recognize the contributions as debt.[81] Section 385 of the Internal Revenue Code autho-

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79. *See* Note, *Toward New Modes of Tax Decisionmaking—The Debt-Equity Imbroglio and Dislocations in Tax Law Making Responsibility*, 83 HARV. L. REV. 1695 (1970). "[N]ot every advance cast in the form of a loan gives rise to an 'indebtedness' which will justify a tax deduction. . . . 'The incidence of taxation depends upon the substance of a transaction,' " not the form. Gilbert v. Commissioner, 248 F.2d 399, 404 (2d Cir. 1957) (quoting Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945)).

> Assuming then that the true nature of the obligation has been established, and that it is not so unlike a classic debt as to preclude treatment as such, the inquiry is not yet ended, for "the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them."

Id. at 403 (quoting Bazley v. Commissioner, 331 U.S. 737, 741 (1947)).

80. Factors favoring debt classification include:

> (1) The corporation will obtain a deduction under § 163(a) [of the Internal Revenue Code] for interest paid on indebtedness (pro tanto avoiding the "double tax" on distributed corporate profits), whereas dividends paid on stock are not deductible.
>
> (2) Payment of debt at maturity may constitute a "reasonable business need" under § 533(a) which will justify an accumulation of earnings and profits and thus help to avoid the penalty tax imposed by § 531; the redemption of stock, however, is less likely to qualify as a "reasonable need of the business."
>
> (3) Payment of principal on the debt will ordinarily be a tax-free recovery of basis to the creditor (or will produce capital gain under § 1232 if collections exceed the adjusted basis of the debt); whereas the redemption of stock is often taxed as a dividend to the redeemed shareholders.
>
> (4) Debt (and to a lesser degree, preferred stock) may be transferred within the family, to outsiders, or donated to charity without diluting the insider's control of the corporation.

B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 4.01 at 4-2 to 4-3 (4th ed. 1979). *See also* 1 F. O'NEAL, *supra* note 4, at § 2.09.

81. In Slappey Drive Indus. Park v. United States, 561 F.2d 572, 580 (5th Cir. 1977), the court stated:

> The problem is particularly acute in the case of close corporations, because the participants often have broad latitude to cast their contributions in whatever form they choose. Taxpayers have often sought debt's advantageous tax treatment for transactions that in substance more closely resembled the kind of arrangement Congress envisioned when it enacted the equity provisions.

rizes[82] the promulgation of regulatory guidelines to distinguish advances to corporations that create a debtor-creditor relationship from advances that create a corporation-shareholder relationship.[83] The regulations do "not inquire into the nature of the debenture—is it stock or indebtedness? Instead, it inquires into the nature of the . . . advance—is it payment for the debenture or part payment for the debenture and part contribution to capital?"[84]

The regulations begin with the presumption that the transaction between the shareholder and the corporation is at arm's length, that the amount of the proceeds advanced equals the fair market value of the bonds, and that the bond instruments represent bona fide indebtedness rather than contributions to equity.[85] A transaction that fails to meet any of the qualitative standards established by the regulations rebuts this presumption. The qualitative standards focus on the shareholder's proportion of debt to stockholding. If the ratio of debt to stockholding is proportionate, the standards also focus on the reasonableness of the bond indebtedness rate of interest and the capital structure of the corporation.[86] Failure to satisfy a qualitative standard indicates a quanti-

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See In re Uneco, Inc., 532 F.2d 1204, 1207 (8th Cir. 1976) (element of control permits creation of fictional debt); Dillin v. United States, 433 F.2d 1097, 1103 (5th Cir. 1970) (family corporation with active management participation by family members indicative of control). *See also* note 4 *supra* and accompanying text.

82. *See* I.R.C. § 385(a).

83. *See* I.R.C. § 385(b). Although Congress granted the statutory authority in 1969, proposed regulations did not appear until March 24, 1980, followed by final regulations on December 31, 1980. The effective date of the regulations for interests created by a corporation is Dec. 31, 1981. IR 81-43 (April 15, 1981).

84. 45 Fed. Reg. 18957, 18959 (1980) (Supplementary Information).

> By posing the question in this way, [the regulation] attains three goals. First, it replaces the subjective analysis of the case law with a definite question—what is the fair market value of the debenture? Second, it remains responsive to the relevant factors identified by the case law. Many of these factors—e.g., maturity date, right to enforce payment, capitalization, ability of the corporation to obtain loans elsewhere—have a direct bearing on fair market value. [The regulation] weighs these factors according to their effect on the fair market value of the debentures. Third, [the regulation] makes it easier for the Government and the taxpayer to reach a compromise. Under the case law, the debenture is one or the other—stock or indebtedness. There is not much room for compromise. . . . The Government does not have to choose between abandoning its position and driving the taxpayer to litigation.

Id.

85. *See* Treas. Reg. § 1.385-4(a) (1980).

86. The small issue exempt industrial development bond is a straight debt instrument, possessing none of the qualities of a hybrid instrument. "The term 'hybrid instrument' means an instrument that is convertible into stock or one (such as an income bond or a participating bond) that provides for any contingent payment to the holder (other than a call premium)." Treas. Reg.

tative discrepancy between the amount advanced and the fair market value of the debt instrument. To the extent the amount of the advance exceeds the fair market value of the debt instrument, the excess is a contribution to capital.[87] If the fair market value of the bond indebtedness exceeds the amount advanced, the excess is a distribution of property to the shareholder.[88]

The principal qualitative factor that indicates the nontax economic substance of the advance is the proportion of debt to stockholding.[89] A shareholder who transfers assets to the corporation assumes the risk of the business and hopes that the investment will appreciate with the corresponding growth of the corporation.[90] The measure of the shareholder's return is the periodic payment of dividends and appreciation in the fair market value of the stock realized upon disposition. A creditor, however, is risk averse, and thus seeks a stable return from debt servicing free from fluctuation in the long term business cycle of the corporation.[91] These nontax economic precepts lose their vitality when the shareholder and creditor are one person or a common group of persons.

Disproportionate holdings of stock and debt instruments by a common group of investors affect their relative nontax economic status. This nontax economic adversity among investors, measured by the priority for investment return and the amount of return, ensures the existence of arm's length bargaining between creditors and shareholders. Because the transaction occurs at arm's length, an absolute presumption arises that an advance for small issue exempt industrial development bonds in an amount not proportionate to stockholdings equals the fair market value of the bonds and thus constitutes bona fide indebtedness.[92]

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§ 1.385-3(e) (1980). All other instruments are straight debt instruments. Therefore, the regulations pertaining to hybrid instruments are not relevant to the small issue exempt industrial development bond.

87. *See* Treas. Reg. § 1.385-3(a) (1980).

88. I.R.C. § 301 determines the tax treatment of a distribution of the property. *See* Treas. Reg. § 1.385-3(b) (1980).

89. *See* Treas. Reg. § 1.385-6 (1980).

90. *See* Slappey Drive Indus. Park v. United States, 561 F.2d 572, 581 (5th Cir. 1977) (stating risk-return relationship for contributor of capital).

91. *See* Portage Plastics Co. v. United States, 470 F.2d 308, 312 (7th Cir. 1972) (differentiates risk-return relationship of equity contributors and creditors); Wilshire & W. Sandwiches, Inc. v. Commissioner, 175 F.2d 718, 721 (9th Cir. 1949) (same).

92. *See* 45 Fed. Reg. 86438, 86440 (1980). *See also* Slappey Drive Indus. Park v. United

Tax consequences aside, shareholders with proportionate holdings of debt and stock are indifferent as to whether the corporation applies profits for debt servicing or distributes profits in the form of dividends. Regardless of the method of distribution, the relative economic status of investors remains the same.[93] When the holdings of bonds and stock are substantially proportionate,[94] the obligations will constitute indebtedness only if the transaction satisfies objective economic criteria that indicate the presence of arm's length bargaining.[95] To test the presence of arm's length bargaining, the regulations establish a reasonable rate of interest test and an excessive debt test. A "second look" rule requires bondholders to enforce the terms of the debt instrument according to an arm's length standard.[96] A change in the terms of the

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States, 561 F.2d 572, 583-84 (5th Cir. 1977) (disproportionate interests result in arm's length bargaining and bona fide debt instrument); Estate of Mixon v. United States, 464 F.2d 394, 409 (5th Cir. 1972) (same). Even though holdings are disproportionate, if externalities remove the incentive of the investor to act as an independent creditor, the Service will treat the disproportionate bondholder as if the holdings were proportionate. For an example of externalities see Treas. Reg. § 1.385-6(a)(7) (1980).

93. *See* 45 Fed. Reg. 86438, 86440 (1980). As early as 1957 the court in Gilbert v. Commissioner, 248 F.2d 399, 407 (2d Cir. 1957), attempted to reason the concern for proportionality:

> An agreement to keep "loans" proportioned to acknowledged risk capital is indicative that the funds "loaned" were understood to have been placed at the risk of the business. There is no apparent reason for such an agreement where repayment seems fairly certain. Such an agreement is readily understood, however, where there is real danger that the money might be lost, for by means of such an agreement each stockholder risking additional capital in the form of a "loan" can be assured that his percentage of the equity and control will remain in correspondence with his shares of the risk. In other words, a reluctance to "lend" money to the corporation unless his fellow shareholders "lend" proportionate amounts belies a feeling of confidence that the funds will be returned regardless of the success of the venture. And the shareholder's understanding of the degree of risk involved is of course relevant in determining what is in fact the degree of risk involved.

Id. See also Slappey Drive Indus. Park v. United States, 561 F.2d 572, 583 (5th Cir. 1977) (proportionate interests, negating nontax considerations, requires increased judicial scrutiny of transaction); Bordo Prods. Co. v. United States, 476 F.2d 1312, 1324 (Ct. Cl. 1973) (equity interest paramount consideration for holder of proportionate debt and equity).

94. The regulations do not establish numerical guidelines for determining proportionality. The Department of Treasury expects to release the standards through a revenue procedure. 45 Fed. Reg. 86438, 86441 (1980). "Substantial proportionality is determined from all relevant facts and circumstances, including family or other relationships described in [the attribution provisions of] section 318(a)." Treas. Reg. § 1.385-6(a)(2) (1980). *See* Treas. Reg. § 1.385-6(a)(6) examples (1)-(3), (7) (1980).

95. "This arm's length standard is necessary because shareholders have no economic incentive to set arm's length terms on proportionately-held debt. Rights foregone by proportionate shareholders in their status as creditors simply enhance the value of their underlying stock interests." 45 Fed. Reg. 86438, 86440 (1980).

96. *See* notes 111-16 *infra* and accompanying text.

instrument or failure to pay interest or principal may indicate the lack of an arm's length relationship between bondholder and corporation.

A reasonable rate of interest "is within the normal range of rates paid to independent creditors on similar instruments by corporations of the same general size and in the same general industry, geographic location, and financing condition on the date the determination is made."[97] The regulations provide a safe harbor, holding that a rate is reasonable if it is equal to the rate charged for underpayment of taxes,[98] the prime rate of any commercial bank, or a rate promulgated by the Secretary of the Treasury based on obligations of the United States of comparable maturity, or any intermediate rate.[99] Because of the tax exempt status of small issue exempt industrial development bonds, the stated interest rate may fall within the range of permissible rates. Furthermore, the corporation must have a debt-equity ratio less than or equal to one-to-one at the end of the taxable year of the bond issue.[100]

If the bond issue fails to satisfy the safe harbor test, the reasonableness of the interest rate depends on the terms of the obligation, including maturity date, terms for redemption, certainty of repayment, and creditor's rights upon default. Terms of a small issue exempt industrial development bond include a fixed maturity date,[101] redemption using the interest method of amortization,[102] and priority upon default as a secured creditor.[103] A close corporation must consider all of these

97. Treas. Reg. § 1.385-6(e)(1) (1980).

98. *See* I.R.C. § 6621.

99. *See* Treas. Reg. § 1.385-6(e)(2)(i) (1980).

100. *See* Treas. Reg. § 1.385-6(e)(2)(ii) (1980).

101. Furthermore, an interest rate may be unreasonable absent a fixed maturity date. The fixed maturity date provides a time frame to evaluate the investment risk. *See* Bordo Prods. Co. v. United States, 476 F.2d 1312, 1321 (Ct. Cl. 1973) (fixed maturity date element of debt instrument); Estate of Mixon v. United States, 464 F.2d 394, 404 (5th Cir. 1972) (absence of maturity date signals advance of equity, returnable only upon the success of the corporate business). *Compare* Scriptomatic, Inc. v. United States, 555 F.2d 364, 372 (3d Cir. 1977) (obligation with fixed payment date held debt) *with* Rolwing-Moxley Co. v. United States, 589 F.2d 353, 355 (8th Cir. 1978) (obligation without fixed maturity date considered stock) *and* Wood Preserving Corp. v. United States, 347 F.2d 117, 119 (4th Cir. 1965) (same).

102. *See* notes 13-16 *supra* and accompanying text.

103. A primary contingency that may effect repayment is the subordination of the obligation. The possibility of subordination presents additional risk that will effect the interest rate required by the creditor. *See* Estate of Mixon v. United States, 464 F.2d 394, 406 (5th Cir. 1972) (priority of claim indicative of creditor-debtor relationship rather than shareholder-corporation). The subordination issue presents no difficulty with regard to industrial development bonds. Because the

characteristics, therefore, when setting a reasonable rate of interest for its shareholder-subscribers.

If the corporation's debt is excessive at the time of the bond issue, the regulations treat a proportionate advance by a stockholder as a contribution to equity.[104] The test for excessive debt queries whether an independent third party creditor, knowing the amount of debt outstanding prior to the current advance, would advance funds under the terms assumed by the shareholder-subscriber.[105] The regulations provide a safe harbor, defining a corporation's amount of debt as permissible if the corporation's outside ratio is less than or equal to ten-to-one and its inside ratio is less than or equal to three-to-one.[106] The outside ratio is the ratio of the corporation's debt to the stockholders' equity.[107] The inside ratio is the ratio of the corporation's debt, excluding liability to independent creditors, to the stockholders' equity.[108] The "inside" designation thus represents only debt leverage resulting from shareholder advances.

The smaller inside ratio prevents excessive debt leveraging by shareholders who earn nontaxable interest income. Normally, the prospect of excessive taxable interest income, regardless of the offsetting corporate deduction, deters excessive proportionate inside debt leveraging. This deterrent is ineffective against small issue exempt industrial development bond subscribers. The tax exempt feature of the bonds permits

small issue exempt industrial development bond must satisfy the "security interest" test, *see* notes 44-48 *supra* and accompanying text, the obligation has a superior position to the general creditors.

104. *See* Treas. Reg. § 1.385-6(f)(1) (1980). *See generally* Caplin, *The Caloric Count of a Thin Incorporation*, 17 N.Y.U. INST. FED. TAX. 771 (1959); Dunn, *Thin Incorporation: The Debt-Equity Issue*, 28 N.Y.U. INST. FED. TAX. 309 (1970); Goldstein, *Corporate Indebtedness to Shareholders: 'Thin Capitalization' and Related Problems*, 16 TAX L. REV. 1 (1960); Hickman, *The Thin Corporation: Another Look at an Old Disease*, 44 TAXES 883 (1966).

105. *See* Treas. Reg. § 1.385-6(f)(2) (1980). *See also* Fischer v. United States, 441 F. Supp. 32, 38 (E.D. Pa. 1977), *aff'd*, 582 F.2d 1274 (3d Cir. 1978) (third-party creditor standard objective measure for bona fide indebtedness). Therefore, "non-arm's length loans by a stockholder to a corporation are to be recognized or disregarded for tax purposes according to the extent to which they comply with arm's length standards, not the extent to which the taxpayer has a business purpose." Nassau Lens Co. v. Commissioner, 308 F.2d 39, 46 (2d Cir. 1962). The result is that "if the shareholder's advance is far more speculative than what an outsider would make, it is obviously a loan in name only." Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968).

106. *See* Treas. Reg. § 1.385-6(f)(3) (1980). Generally the adjusted basis of assets and liabilities is figured in accordance with tax accounting standards used to compute taxable income. Treas. Reg. §§ 1.385(g)(3), .385(g)(4) (1980).

107. *See* Treas. Reg. § 1.385-6(f)(4) (1980).

108. *Id.*

corporate deductions without a corresponding recognition of interest income.[109] Within the ambit of the safe harbor provisions, therefore, the inside debt-equity ratio is a ceiling for proportionate shareholder subscriptions to the bond issue.

Although the close corporation fails to satisfy the safe harbor provisions, the debt-equity ratio may still satisfy the standards on excessiveness if a commercial lending institution would subscribe to the bond issue. Any resolution of this standard must consider the corporation's size, industry, geographic location, and financial condition.[110]

A change in circumstances, represented by a change in the terms of the debt instrument[111] or the failure to meet an obligation of the indenture,[112] may result in reclassification from debt to equity. A change in terms must be substantial.[113] The regulations equate substantial with a change that could materially affect the fair market value of the instrument.[114] Examples include subordination or a change in the interest rate. Changes that are generally insubstantial include substitution of collateral and prepayment of indebtedness.[115] Failure to pay any part of principal or interest may result in reclassification if the bondholder fails to exercise the due diligence of an independent creditor.[116]

B. *Shareholder Forfeiture of Interest Income Exemption*

Although the shareholder advance for the close corporation's small issue exempt industrial development bond constitutes bona fide indebtedness, the interest income from the bonds may lose its tax exempt status. The tax exempt benefit is inapplicable to bonds held by a person who is a "substantial user" of the facilities obtained with bond proceeds or a "related person" to a substantial user.[117] There are two ways to

109. *See* 45 Fed. Reg. 86438, 86441 (1980).

110. *See* Treas. Reg. § 1.385-6(f)(2) (1980).

111. *See* Treas. Reg. § 1.385-6(j) (1980).

112. *See* Treas. Reg. § 1.385-6(k) (1980).

113. *See* Treas. Reg. § 1.385-6(j)(2) (1980).

114. *Id.*

115. *Id.*

116. *See* Treas. Reg. §§ 1.385-6(k),-6 (*l*)(iii) (1980). The court in Slappey Drive Indus. Park v. United States, 561 F.2d 572, 582 (5th Cir. 1977), stated that "[t]he individuals' failure to insist upon timely repayment . . . indicates that the compensation they sought went beyond the announced interest rate, for an investor would not ordinarily undertake such a risk for so limited a return." *Id.*

117. *See* I.R.C. § 103(b)(8); Treas. Reg. § 1.103-11(a) (1972). The substantial user disqualifi-

qualify as a substantial user.[118] A person is a "substantial user" if that person obtains a facility and receives significant commercial or economic benefit[119] from its regular use.[120] The close corporation is a "substantial user" because it receives the direct economic benefit of capital asset expansion. Any economic benefit accruing to the shareholder is derivative, reflected either by increased dividends or appreciation in the value of stock.[121] The regulations also define a "substantial user" as any person who derives more than five percent of the total

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cation of the exemption benefit derived from the belief that such activity was a misuse of the cooperative venture between the corporation and the government unit.

> Industrial development bond arrangements are vulnerable to misuse and examples of malpractice can be found. . . . One of these occurs when the firm for whom the facility is constructed has access to adequate financing through conventional channels. The abuse is particularly glaring when the benefited enterprise itself acquires tax exempt bonds issued to finance the structure it occupies, thus becoming also the beneficiary of tax exempt income.

ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, INDUSTRIAL DEVELOPMENT BOND FINANCING 13-14 (A-18, June 1963). To curtail this abuse, the Revenue and Expenditure Control Act of 1968 restricted the interest exemption resulting from the conduit arrangement. This restriction indicated Congress' intent to provide the subsidy only to those firms in need of investment assistance. *See* Pub. L. No. 90-364, 82 Stat. 251 (1968).

118. *See* Treas. Reg. § 1.103-11(b) (1972).

119. *See* 152 IRS LTR. RUL. REP. (CCH) No. 8003059 (Oct. 24, 1979) (members of professional accounting society not considered substantial users of building constructed to house professional association because "the Society's members will not receive a significant commercial or economic benefit from the operation of the building in their trade or businesses as accountants"). *But cf.* Treas. Reg. § 1.103-11(b) (1972) example 3 (dentists and doctors considered substantial users of building constructed specifically for their use).

120. *See* Treas. Reg. § 1.103-11(b) (1972).

121. Neither the courts nor the Internal Revenue Service has addressed the issue of whether a shareholder in a close corporation is a substantial user. The regulations, under Treas. Reg. § 1.103-11(b) (1972), provide that "[a]bsent 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." *Id.* In the close corporation the shareholder will assume a position on the board of directors or as officer or both. "Generally, an officer of a corporation is an employee of the corporation. . . . A director of a corporation in his capacity as such is not an employee of the corporation." Treas. Reg. §§ 31.3401(c)-(f) (1975). Aside from the exclusion for employees, the Code indicates an intention to separate the close corporation, as a substantial user, from its shareholders because of the express restrictions on "related persons." If a shareholder was considered a "substantial user" there would be no need for the "related person" criteria. Although the Code language indicates an intention to resolve the treatment of the close corporation and its shareholders in the context of an entity approach, the Internal Revenue Service applies an aggregate approach to a cooperative and its members. Therefore, in Rev. Rul. 76-406, 1976-2 C.B. 30, the Internal Revenue Service held that "the facilities will be constructed specifically for members of the farmers' cooperative. . . . Accordingly, the members . . . will be substantial users of the . . . facility. . . . Interest to be received on the bonds held by such substantial users will be includible in their gross incomes." *Id.* at 31. *See also* Rev. Rul. 79-367, 1979-2 C.B. 38 (interest exemption forfeited by bondholders considered substantial users).

revenue generated from the facility and occupies more than five percent of the total usable area.[122]

A shareholder may qualify as a "related person" to the close corporation—substantial user if the shareholder owns, directly or indirectly, more than fifty percent of the value of the outstanding stock of the close corporation. The regulations resolve the question of ownership, whether direct or indirect, by applying the attribution rules for constructive ownership of stock.[123] In addition to the stock in which the shareholder maintains a legal interest, constructive ownership includes stock owned by a family member over which the shareholder may assert control, or stock owned beneficially where legal title resides in another.[124] The regulations provide a method to calculate the value of all constructively owned shares. If this value exceeds fifty percent of the value of the outstanding stock, the regulations attribute control of the close corporation to the shareholders.[125] As a result, the related person-shareholder loses the interest income exemption on small issue exempt industrial development bonds.[126]

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122. *See* Treas. Reg. §§ 1.103-11(b), (c) (1972).

123. *See* I.R.C. § 103(b)(6)(C). The Code provides:

> [A] person is a related person to another person if (i) the relationship between such persons would result in a disallowance of losses under section 267 or 707(b), or (ii) 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' . . . .

Id.

124. *See* I.R.C. § 267(c); Treas. Reg. § 1.267(c)-1 (1972). Congress has continually expressed concern about abuses of multiple personalities. "By this device [the taxpayer] ceases to be a single individual and becomes a whole group of people, . . . sometimes incorporated and sometimes not. . . . Each of these imaginary individuals into which the taxpayer divides himself deals and trades with all the other imaginary individuals." *Hearings Before the Joint Committee on Tax Evasion and Avoidance, Part I*, 75th Cong., 1st Sess. 11 (1937) (statement of Secretary Morgenthau).

This theory of one economic unit supports the constructive stock rules for determining the shareholder's interest and the requirement that a shareholder, once classified as a related person, be treated synonymous with the substantial user/corporation. "Control includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise." [1958] 2 STAND. FED. TAX REP. (CCH) ¶ 2242.10, at 26072. A related person thus cannot benefit from the exemption feature of the small issue exempt industrial development bond.

125. *See* I.R.C. § 267(b). *But see* King, Quirk & Co. v. Commissioner, 20 T.C.M. (CCH) 1429, 1440 (1961) (court stated in dicta that voting power may be of some relevance if stock values are not readily ascertainable).

126. *See* I.R.C. § 103(b)(8).

IV. CONCLUSION

The small issue exempt industrial development bond is a statutorily created instrument reflective of the complex interdependence of legal and financial planning for the close corporation.[127] The bond provides the subscriber with tax exempt interest income. Consequently, the financial planner obtains the benefit of a lower cost of capital for the close corporation's capital asset expansion. The close corporation does not enjoy unfettered discretion, however, regarding the use of the bond proceeds. The legal parameters of the statute limit both the use of the bond proceeds and the form of the bond issue. These limitations should not deter the close corporation. The financial advantages far outweigh the legal limitations.

The astute planner recognizes the importance of planning not only for the close corporation, but for its shareholders as well. The financial well-being of the two entities is inseparable. From the standpoint of the shareholder, an additional financial incentive to using the bonds, aside from the indirect benefit that results from favorable corporate tax treatment, may exist. The shareholder may subscribe to the bond issue, enjoy the benefits of tax exempt income, and have the close corporation

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127. *See Hearings Before the Joint Committee on Tax Evasion and Avoidance, Part I*, 75th Cong., 1st Sess. 9-11 (1937) (statement of Secretary Morgenthau):

> In the first place, we have developed in this country a group of ingenious lawyers and accountants who make their living by showing to people who can afford to employ them ways by which they may pay the least possible taxes. This may be a legitimate business. Nevertheless, by virtue of its highly competitive character, it brings about the following situation: The ordinary accepted standard by which many wealthy taxpayers judge the efficiency of the tax attorney is the amount that he can save in taxes. The most ingenious attorney, therefore, becomes the most successful and the most sought after. He feels that his sole duty is toward his client. If he is honest, he will not condone perjury, but he feels little moral or social responsibility to the Government. Therefore, if he can invent a new scheme for circumventing the intent of tax laws, which will be upheld by the courts, he is well within the ethics of his profession, regardless of the unfortunate effect that such a scheme will have upon the general application of such laws.
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> . . . .
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> A second factor which creates the problem which now confronts us is the fact that tax avoidance, as opposed to tax evasion, is considered by many a legitimate and honorable aim.
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> . . . .
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> These attitudes have created what might be called the sporting theory of tax administration. So long as these attitudes exist, the process of tax legislation will be somewhat as follows: A law will be passed; ingenious devices for circumventing its application to individuals will be tried out. This will take time. Finally, when sufficient of those devices have become current so that a great loss in governmental revenue begins to appear, legislation will have to be drafted specifically directed at the new tax-avoidance inventions which have appeared since the last law.

Id.

take a deduction for interest payments even though the substance of the transaction is no different than a contribution to equity.

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