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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Mary Oppenheimer
Assistant Chief Counsel CC:TEGE:EOEG:TEB

SUBJECT: Use of Proceeds for Small Issue Bonds

This Field Service Advice responds to your memorandum dated September 22, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND

Issuer =
Bonds =

Corporation	=
Individual	=
Partnership	=
Conduit Borrower	=
City	=
State	=
Year 1	=
Date 1	=
Date 2	=
Date 3	=
<u>\$a</u>	=
<u>\$b</u>	=
<u>\$c</u>	=

ISSUE

Whether a payment made from the proceeds of a tax-exempt bond was used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation within the meaning of section 144(a)(1).

CONCLUSION

Based on the available information, we are unable to provide a determination as to whether the payment in question was used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation within the meaning of section 144(a)(1).

FACTS

Corporation was formed for the purpose of developing nursing homes and similar facilities in State. Corporation is owned by Individual.

During the period in issue, a certificate of need was required to construct or operate a nursing home in State. The certificate of need was provided once the facility is approved by the State. During a four year period ending in Year 1, Corporation and another entity owned by Individual expended more than \$a for costs related to the acquisition of certificates of need and other unspecified costs related to the development of nursing homes.

On or about Date 1, the State issued a certificate of need to Corporation for developing a nursing home facility (the "Project") in City, located in State. Corporation was to own the Project and Partnership, an unrelated entity, would be

the manager.¹ In order to comply with the rules applicable to tax-exempt bonds, it was determined that Project could not be financed with tax-exempt financing if Corporation was the owner. As a result, Conduit Borrower, a general partnership, was formed on Date 2. Subsequently, Corporation's certificate of need for the Project was transferred to Conduit Borrower. Corporation holds a 50% interest in Conduit Borrower.

On Date 3, Issuer issued its Bonds in the amount of \$b. The proceeds of the Bonds were loaned to Conduit Borrower for the acquisition and construction of the Project.

At the time of the issuance of the Bonds, Corporation received a payment from Bond proceeds in the amount of \$c (the "Payment"). Corporation, Conduit Borrower, and Issuer (collectively the "Taxpayers") assert that the Payment represented an amount owed to Corporation by Conduit Borrower for pre-construction development activities and work performed by Corporation in connection with the Project prior to the date that Conduit Borrower was formed. The Taxpayers assert that Corporation incurred costs for the Project relating to: researching the market; conducting feasibility studies; participating in the design of the Project; identifying locations for the Project; and developing a business plan for Conduit Borrower to follow in the acquisition, construction, and operation of the Project. According to the Taxpayers, the Payment reimbursed Corporation for the costs it incurred in connection with these activities and provided a reasonable profit.²

Your memorandum states that the Taxpayers have not produced any contracts, invoices, or other records establishing the actual purpose for the Payment. You indicate that the records fail to establish that Corporation was involved in the acquisition or construction of the Project, but rather they show that Corporation's activities were primarily limited to performing economic research and other activities related to obtaining tax-exempt financing. Your memorandum also indicates that the direct costs of developing the Project were generally paid by the Partnership.

LAW AND ANALYSIS

Section 103(a) of the Internal Revenue Code provides that, except as provided in subsection (b), gross income does not include interest on any state or

¹ Your memorandum indicates that there were cost overruns on the Project and that additional equity was contributed by Partnership within two years of the issuance of the Bonds.

² Based on the Taxpayers' statements, it is unclear if any portion of the Payment represents Corporation's cost of acquiring the certificate of need for the Project.

local bond. Subsection (b) provides, in part, that subsection (a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of section 141).

Section 141(e) provides, in part, that the term "qualified bond" includes any private activity bond if such bond is a qualified small issue bond. Section 144(a)(1) provides, in part, that the term "qualified small issue bond" means any bond issued as part of an issue the aggregate authorized face amount of which is \$1,000,000 or less and 95 percent or more of the net proceeds of which are to be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation.

Treas. Reg. § 1.103-10(b)(1)(ii) states that an exempt small issue is an issue where, among other things, substantially all of the proceeds of the issue are used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation under section 167.³ Proceeds which are loaned to a borrower for use as working capital or to finance inventory are not used for the acquisition, construction, reconstruction or improvement of land or depreciable property. Whether substantially all of the proceeds of an issue of governmental obligations are used in such manner is determined consistently with the rules for exempt facilities in Treas. Reg. § 1.103-8(a)(1)(i).

Section 1.103-8(a)(1)(i) states, in part, that substantially all of the proceeds of an issue of governmental obligations are used to provide an exempt facility if 90% or more of such proceeds are so used.⁴ For purposes of this test, two rules apply. First, proceeds are reduced by amounts properly allocable on a pro rata basis between providing the exempt facility and other uses of the proceeds. Second, amounts used to provide an exempt facility include amounts paid or incurred which are chargeable to the facility's capital account or would be so chargeable either with a proper election by taxpayer or but for a proper election by a taxpayer to deduct such amounts.⁵

³ Section 167(a) permits as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business, or property held for the production of income.

⁴ Former section 103(b)(6)(A) of the 1954 Code, the predecessor to section 144(a) of the 1986 Code, merely provided that "substantially all" of the proceeds had to be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation. Section 144(a) clarifies that 95 percent of the net proceeds have to be used for the specified purposes.

⁵ Current Treas. Reg. § 1.150-1(b) defines the term "capital-expenditure" for purposes of sections 103 and 141 through 150. Section 1.150-1(b) states that a capital

Section 263(a)(1) provides generally that any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate must be capitalized. Treas. Reg. § 1.263(a)-2(a) further provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures and similar property having a useful life substantially beyond the taxable year.

Capital expenditures under section 263 are not deductible in the year of the expenditure, but rather must be added to the basis of the capital asset with respect to which they are incurred. Woodward v. Commissioner, 397 U.S. 572, 574-575 (1970). Deductions, by contrast, are exceptions to the norm of capitalization and are subject to disallowance in favor of capitalization. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). The principal effect of characterizing a payment as either an ordinary expense or a capital expenditure concerns the timing of the taxpayer's cost recovery. A business expense is currently deductible, while a capital expenditure is normally amortized and depreciated over the life of the relevant asset, or, if no specific asset or useful life can be ascertained, is deductible upon dissolution of the enterprise. Id. 83-84. Whether an expenditure is an ordinary expense or is capital in nature is a question of fact that depends on the context in which the expenditure is incurred. See Commissioner v. Idaho Power, 418 U.S. 1 (1974). The burden of establishing the right to a particular characterization of an expenditure is on the taxpayer. See INDOPCO, Inc. v. Commissioner, 503 U.S. at 84.

Ancillary expenses incurred in acquiring or disposing of an asset are as much a part of the cost of the asset as the price paid. For example, legal, brokerage, accounting, appraisal, and similar costs incurred to acquire a capital asset are capital expenditures under section 263. See Rev. Rul. 99-23, 1999-1 C.B. 998; Woodward v. Commissioner, 397 U.S. 572 (when property is acquired by purchase, nothing is more clearly a part of the process of acquisition than the establishment of a purchase price); see also Rev. Rul. 74-104, 1974-1 C.B. 70 (evaluation expenses incurred by a developer, including feasibility research, salaries, and travel, are capital because they were incurred in connection with acquiring a specific piece of property which was of benefit beyond the current taxable year).

expenditure means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under section 1.150-2(c)) under general Federal income tax principles. For example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures. Whether an expenditure is a capital expenditure is determined at the time the expenditure is paid with respect to the property. Future changes in law do not affect whether an expenditure is a capital expenditure.

The current inquiry is whether the Payment can be characterized as used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation within the meaning of section 144(a)(1). If it cannot, your memorandum indicates that less than 95 percent of the net proceeds of the Bonds will be used for the purposes specified in section 144(a)(1).

The Taxpayers contend that the Payment was for pre-construction development activities performed by Corporation in connection with the Project. These activities purportedly include: conducting feasibility studies and researching the market; identifying locations for and participating in the design of the Project; and developing a general business plan for the acquisition, construction, and operation of the Project. While there appears to be some dispute as to whether any portion of the Payment to Corporation relates to the certificate of need, the facts provided indicate that Corporation incurred significant expenses in acquiring the certificate of need necessary for operating the Project.

It is clear that the certificate of need for the Project and the Project itself constitute capital assets. A facility such as the Project is a capital asset whether it is purchased or constructed. Commissioner v. Idaho Power, 418 U.S. 1. Moreover, the certificate of need is capital in nature because it is a separate and distinct asset that produces a long-term benefit; the right to operate the Project. It is analogous to a license. The costs of obtaining a license with a useful life greater than one year to conduct a business are the costs of obtaining a capital asset. See Rev. Rul. 86-71, 1986-1 C.B. 102; Dustin v. Commissioner, 53 T.C. 491 (1969) aff'd, 467 F.2d 47 (9th Cir. 1972).

Based on the Taxpayers' assertions as to the purpose for the Payment, some or all of the Payment may be properly chargeable to the Project's capital account and of a character within the meaning of section 144(a)(1). For example, the Taxpayers contend that the Payment relates directly to activities such as identifying locations for and participating in the design of the Project which would generally be considered part of the cost of developing the Project.

Your examination of the Taxpayers' records does not corroborate their assertions regarding the purpose for the Payment. You state that the available records indicate that Corporation's activities, apart from obtaining the certificate of need, involved economic research and other activities related to obtaining tax-exempt financing. Without additional information regarding these alleged activities, however, we cannot determine if they meet the requirements of section 144(a)(1). Moreover, the Taxpayers have not provided any documentation prepared contemporaneously with the Payment detailing its purpose. Absent such documentation we are unable to provide an unqualified opinion as to the proper characterization of the Payment and, as a result, whether the 95 percent test of section 144(a)(1) has been met.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]



Please call if you have any further questions.

By: TIMOTHY L. JONES
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Tax Exempt Bond Branch