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JUL 28 1999

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director:

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN:

Tax Years Involved:

Legend:

City =

Bonds =

Date 1 =

Date 2 =

Company A =

Company B =

Individual X =

Individual Y =

a =

b =

173

ISSUE:

Whether Individual X's purchases of land and a partnership interest from a related person, Individual Y, within the 3- year period preceding the issue date of the Bonds, are capital expenditures under § 144(a)(4) of the Internal Revenue Code.

CONCLUSION:

The purchase by Individual X of land from Individual Y is a capital expenditure for purposes of § 144(a)(4). The purchase by Individual X of the partnership interest from Individual Y, is a purchase of the assets of the partnership. To the extent that the amount paid for the partnership assets is properly chargeable to a capital account, it is a capital expenditure for purposes of § 144(a)(4).

FACTS:

City issued the Bonds on Date 1 as qualified small issue bonds under § 144(a). City elected the $10,000,000 limitation of § 144(a)(4) in its books and records and on the information return (Form 8038) filed with the Internal Revenue Service.

The form of the transaction is that City would use the proceeds of the Bonds to expand and equip a manufacturing facility located in City and then lease this facility to Individual X d/b/a Company A.[1] For federal tax purposes, however, it is undisputed that Company A is the owner of the bond financed facility. Company A leased the facility to Company B. Company B is solely owned by Individual X.

On Date 2, Company A was formed when a partnership between Individual Y and his son, Individual X, was dissolved and Individual X purchased Individual Y's 50% interest in the partnership. Date 2 is within the 3- year period preceding the issue date of the Bonds. Individual X paid $a for Individual Y's 50% interest in the partnership. All of the partnership's, and later Company A's, assets were leased to Company B during the 3-year period preceding and the 3-year period following the issue date of the Bonds.

Also on Date 2, Individual X purchased a parcel of land from Individual Y for $b. The land was leased to Company B throughout the 3-year period preceding and 3-year period following the issue date of the Bonds.

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[1]The activities of Company A were reported on Individual X's schedule E. For simplicity, this memorandum will refer to Individual X d/b/a Company A as Company A.

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 local bond.

Section 103(b) provides that § 103(a) does not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141 defines the term "private activity bond" and provides, in subsection (e), that the term "qualified bond" means any private activity bond if, in pertinent part, the bond is a qualified small issue bond.

Section 144(a)(1) defines the term "qualified small issue bond" to mean 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 (A) for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation, or (B) to redeem part or all of a prior issue that was issued for the purposes noted in (A).

Section 144(a)(4)(A) generally provides that, at the election of the issuer with respect to any issue, § 144(a) shall be applied by substituting "$10,000,000" for "$1,000,000." If this election is made, in determining whether the $10,000,000 limit is exceeded the issuer must take into account certain prior issues and the aggregate amount of capital expenditures paid or incurred with respect to certain facilities during the 6-year period beginning 3 years before the date of such issue and ending 3 years after such date (and financed other than out of proceeds of outstanding tax-exempt bonds to which § 144(a)(1) applies).

Section 144(a)(4)(B) provides, in part, that the facilities referred to in § 144(a)(4)(A) are facilities (A) located in the same incorporated municipality or located in the same county (but not in any incorporated municipality), and (B) the principal user of which is or will be the same person or 2 or more related persons.

Section 144(a)(3) provides that for purposes of § 144(a), a person is related to another person if (A) the relationship between such persons would result in a disallowance of losses under §§ 267 or 707(b), or (B) such persons are members of the same controlled group of corporations (as defined in § 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears therein). Under § 267, losses are disallowed between certain family members, including ancestors, and between an individual and a corporation when more than 50% in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for such individual.

In this case, Company B is related to Individual X because Individual X is the sole owner of that company. I.R.C. § 267(b)(2). In addition, Individual X is related to Individual Y because of their family relationship. I.R.C. § 267(b)(1) and (c)(4).

Section 103(b)(6) of the Internal Revenue Code of 1954 contained an exemption for certain small issues of industrial development bonds. In the Tax Reform Act of 1986, Congress amended § 103 of the 1954 Code, reorganized the provisions formerly contained in that section, and placed provisions relating to qualified small issue bonds in § 144(a) of the 1986 Code. Tax Reform Act of 1986, § 1301(a) and (b), 1986-3 C.B. (Vol. 1) 519,520. The Conference Report to the Tax Reform Act of 1986 states that "[t]he conferees intend that, to the extent not amended, all principles of present law continue to apply under the reorganized provisions." 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-686 (1986), 1986-3 (Vol. 4) C.B. 686.

Section 1.103-10(b)(2)(ii) of the regulations provides that an expenditure is a section 103(b)(6)(D) capital expenditure if,

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> (c) The principal user of the facility in connection with which the property resulting from the capital expenditures is used and the principal user of the facility financed by the proceeds of the issue in question is the same person or two or more related persons (as defined in section 103(b)(6)(C) and paragraph (e) of this section), and
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> . . .
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> (e) The capital expenditures were properly chargeable to the capital account of any person or State or local governmental unit (whether or not such person is the principal user of the facility or a related person) determined, for this purpose, without regard to any rule of the Code which permits expenditures properly chargeable to capital account to be treated as current expenses . . . .

Section 1.103-10(b)(2)(iv) and (v) sets forth certain expenditures that will not be treated as capital expenditures for purposes of § 103(b)(6)(D) (the predecessor to § 144(a)(4)). None of these exceptions apply to Individual X's acquisition of Individual Y's land and partnership interest.

Rev. Rul. 77-146, 1977-1 C.B. 24, provides that the contribution of land in exchange for an interest in partnership is not a § 103(b)(6)(D) capital expenditure because the contribution represents a change in the form of ownership and does not result in recogition of gain or loss.

This case is distinguishable from Rev. Rul. 77-146 because upon Individual X's acquisition of Individual Y's partnership interest, the partnership dissolved. In substance, individual X did not acquire a partnership interest, rather he must be viewed as having acquired Individual Y's share of the assets of the partnership. There was not merely a change in the form of ownership.

In the instant case, Companies A and B are the principal users of the Bond financed facility. Individual X was related to Company B during the relevant years. Within the 3-year period preceding the issue date of the Bonds, Individual X's asset purchases from Individual Y were at least in part properly chargeable to a capital account. The assets purchased were located in City and Individual X's expenditures for the assets are not excluded from being capital expenditures under § 144(a)(4).

We thus conclude that the purchase by Individual X of the land from Individual Y and the purchase by Individual X of Individual Y's share of the partnership assets, to the extent properly chargeable to a capital account, are capital expenditures under § 144(a)(4).