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**Tax Notes: An Overview of the Small-Issuer Exemption**

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The Tax Reform Act of 1986 extended the rebate requirement to all issuers, including small issuers. Small municipal issuers account for a large portion of the volume of issues in municipal markets. Section 148(f) of the Internal Revenue Code of 1986 (the Code) generally requires that investment earnings on bond proceeds in excess of the yield of the bonds be rebated to the federal government. There is an exemption from the rebate requirement for certain governmental units issuing \$5 million or less of bonds (Code Section 148(f)(4)(D)).

In order for an issuer to be eligible for this "small-issuer" exemption, the following four requirements must be met. First, the issuer must be a governmental unit with general taxing powers. Second, the bonds may not be private-activity bonds. Third, at least 95% of the proceeds of the bonds must be for local governmental activities of the issuer. Fourth, the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by the issuer during the calendar year must not reasonably be expected to

exceed \$5 million. The most common issue that arises with respect to the small-issuer exemption is whether an issuer has exceeded the \$5 million limitation. The private activity bond and local governmental activities requirements are generally self-explanatory and will not be discussed in this article.

### **Governmental Unit With General Taxing Powers**

A governmental unit has general taxing powers if "it has the power to impose taxes (or to cause another entity to impose taxes) of general applicability which, when collected, may be used for the general purposes of the issuer" (Treas. Reg. §1.148-8(b)). This taxing power may be limited to a specific type of tax as long as its applicability is not limited to a small number of persons and the governmental unit's exercise of the taxing power may be subject to procedural limitations such as voter approval, but it may not be contingent on approval by another governmental unit.

#### ***Allocation of Size Limitation to Subordinate Governmental Unit***

Because the small-issuer exemption is limited to governmental units with general taxing powers, the question arises as to whether an entity without general taxing powers qualifies for the small-issuer exception. If the issuing entity is subordinate to an entity with general taxing powers and the entity with general taxing powers allocates its size limitation to this subordinate entity, then the subordinate entity may take advantage of the small-issuer exemption. For example, an issuer with general taxing powers may allocate all or a portion of its \$5 million size limitation to a subordinate

entity (including an "on-behalf-of" issuer) as long as the allocation is irrevocable and bears a "reasonable relationship to the benefits received by the allocating unit". In analyzing such benefits, the manner in which (1) proceeds are to be distributed, (2) debt service is to be paid, (3) the financed facility is to be owned, (4) the use or output of the facility is to be shared, and (5) costs of operation and maintenance are to be shared must be considered. Size limitation allocations may be made in any reasonable manner, must be irrevocable, and must be made before the date of issue of the bonds. Such allocations are customarily made in bond resolutions, indentures, or similar documents.

### **Aggregation of "On-Behalf-of" Issuers and Treatment of Conduit Loans**

An issuer and all entities that issue bonds "on behalf of" such issuer must be treated as the same issuer for purposes of the \$5 million limitation (Code Section 148(f)(4)(D)(ii)(I)). "On-behalf-of" issuers do not include political subdivisions (Treas. Reg. §1.148-8(c)(2)(i))<sup>1</sup>. This exception is logical because political subdivisions are capable of issuing bonds "on their own" and need not rely upon the legal authority of another governmental unit to incur municipal debt.

Bonds issued for the purpose of making loans to other governmental units with general taxing powers, (which borrowing governmental units are not subordinate to the lending issuer) are not treated as issued by the lending issuer for purposes of the \$5 million limitation. They are treated as issued by the borrowing governmental unit. This exception can be demonstrated by the following example: City A issues \$9 million principal amount of bonds, and loans \$3 million of the proceeds to City B, \$3 million of the proceeds to City C,

and \$2 million of the proceeds to City D. City A retains \$1 million of the proceeds for its own governmental uses. For purposes of determining the amount of bonds issued by City A under the \$5 million limitation, City A is deemed to have issued only \$1 million of bonds (the \$8 million loaned to Cities B, C and D are not taken into account).<sup>2</sup>

In determining their own small-issuer status, conduit borrowers in a pooled financing may ignore the size of the pool issue and the loans made to other conduit borrowers if: (1) the pooled financing bonds are not private activity bonds; (2) none of the loans to the conduit borrowers are private activity bonds; and (3) the loan to the conduit borrower in question meets all of the requirements of the small-issuer exemption.

Applying these rules to the example above, assume that City B had previously issued \$1 million of tax-exempt governmental bonds during the calendar year and that neither City A's pool bonds nor any of the conduit loans to Cities B, C and D were private activity bonds. City B would be eligible for small-issuer treatment on its conduit loan, since the \$3 million it borrowed from the pool plus the \$1 million it had previously issued during the calendar year did not exceed \$5 million. It should be noted that the pool lender or any one of the conduit borrowers can conceivably spoil the exemption for the other conduit borrowers. For example, if City A used its \$1 million of retained bond proceeds in a manner that would cause the pool bonds to be treated as private activity bonds, then the requirement that the pool bonds not be private activity bonds would be violated. Thus presumably none of the conduit borrowers would be eligible for small-issuer treatment with respect to their conduit loans.

## **Aggregation of Subordinate Entities**

For purposes of determining the \$5 million limitation, bonds issued by a subordinate entity are "also treated as issued by each entity to which it is subordinate" (Code Section 148(f)(4)(D)(II)). An issuer is subordinate to another governmental entity if it is directly or indirectly controlled by the other entity. One entity directly controls another entity if it has the power both to approve and to remove without cause a controlling portion of the governing body of the controlled entity - or the power to require the use of funds or assets of the controlled entity for any purpose of the controlling entity (Treas. Reg. §1.150-1(e)).<sup>3</sup> This type of aggregation is known as upstream aggregation. For example, assume that Agency B, an entity subordinate to City A, issues \$4 million of governmental-purpose bonds and City A issues \$3 million of governmental-purpose bonds. Because City A must take into account "all bonds issued by a subordinate entity", the \$4 million of bonds issued by Agency B are treated as issued by City A and, therefore, City A's combined total is \$7 million. On the other hand, City A's \$3 million of bonds are not taken into account by Agency B, since City A is not subordinate (*i.e.*, "down-stream") to Agency B. Apparently, Agency B need not count the \$4 million of bonds issued by City A and, therefore, Agency B only has \$3 million of bonds counted toward its \$5 million limitation. However, it should be noted that an entity formed or availed of to avoid the aggregation rules is aggregated with "all other entities benefiting thereby" (Code Section 148(f)(4)(D)(iv)) and, therefore, under this rule, it is possible that City A's \$4 million of bonds would be aggregated with Agency B's bonds if Agency B was used as a means of circumventing the \$5 million limitation.

There has been no guidance from the IRS regarding the application of the "formed or availed" standard.

### **Application of the Small-Issuer Exemption to Refundings**

When considering a refunding issue and the small-issuer exemption, two separate inquiries must be made. The first inquiry is whether the refunding issue is exempt from rebate under the small-issuer exemption, and the second inquiry is whether the amount of the refunding issue is taken into account for purposes of the issuer's \$5 million limitation. In determining whether the refunding issue is exempt as a small issue, the refunding portion of an issue is treated as a separate issue and will only qualify as a rebate-exempt small issue if (1) the aggregate face amount of the issue does not exceed \$5 million; (2) the issue being refunded was a rebate-exempt small issue;<sup>4</sup> (3) the average maturity date of the refunding bonds is not later than the average maturity date of the refunded bonds; and (iv) no refunding bond has a maturity date later than 30 years after the date the original new money bond was issued.<sup>5</sup>

The refunding portion of an issue is treated as a separate issue for purposes of this analysis.<sup>6</sup> This means that an issue that is part new money and part refunding is treated as two separate issues for purposes of small-issue determination. For example, assume that in 1997 City X issues \$6 million principal amount of bonds, \$2 million of which will be used to currently refund a bond issued in 1992, the remaining \$4 million of which will be used to finance a governmental project. The \$6 million issue will be treated as two separate issues, consisting of a \$2 million refunding issue and a \$4 million

new-money issue. Assuming that (1) the 1992 bonds qualified as a rebate-exempt small-issue, (2) that the average maturity of the \$2 million portion allocated to the refunding bonds is not later than the average remaining maturity of the 1992 bonds, and (3) the maturity date of the refunding bonds is not later than 30 years after the issue date of the 1992 bonds, then the refunding bonds will be exempt from rebate as small-issue bonds.

Current refunding bonds are not taken into account for purposes of the issuer's \$5 million limitation to the extent they do not exceed the outstanding amount of the refunded bonds. Advance refunding bonds are not eligible for this exception and count fully against the \$5 million limitation. Continuing the example above, assume that the outstanding principal amount of the 1992 bonds being refunded is \$1,500,000. The refunding portion of the 1997 bonds of \$2 million exceeds the outstanding amount of the 1992 bonds by \$500,000 and, therefore, \$500,000 must be counted towards City X's \$5 million limitation, resulting in \$4,500,000 of the limitation being used (\$4,000,000 of the 1997 bonds' new money portion plus \$500,000 of the excess of the 1997 bonds' refunding portion over the 1992 bonds). If the 1997 bonds' refunding portion was an advance rather than a current refunding, the entire \$2 million refunding portion would be counted, causing City X to surpass its \$5 million limitation (\$4,000,000 new money portion plus \$2,000,000 advance refunding portion, equaling \$6,000,000).

## **Conclusion**

Many relatively small issuers do not fit within small issuer exemption, because the \$5 million annual threshold is unrealistically small.<sup>7</sup> There have been a number of proposals since the enactment of the Tax Reform Act of

1986 to raise the \$5 million threshold but, to date, Congress has not increased it. One suggestion has been to raise the threshold to \$10 million to be consistent with the bank-qualified small-issuer exception (Code Section 265(b)(3)). Another suggestion has been to increase the threshold to \$25 million, because at such a level a significant portion of all municipal issuers would be exempt from the rebate requirement. Some studies have suggested that issuers of \$25 million or less of bonds a year account for 80 percent of all municipal issuers, while only accounting for less than 20 percent of actual dollar volume of bonds issued. This means that by raising the small-issuer exemption threshold to \$25 million, 80 percent of all tax-exempt bond issuers could be relieved of the burden of rebate while only 20 percent of the total dollars of bonds issued would be exempt from rebate. The recently enacted Taxpayer Relief act of 1997 (HR 2014) increased the \$5 million threshold by up to an additional \$10 million for issues that finance construction of "public school facilities" (i.e., an issuer may issue up to \$5 million of bonds for any governmental purposes and may also issue an additional \$5 million of bonds for public school facility construction). This modest increase in the \$5 million threshold is a good start, and perhaps Congress will recognize the tremendous cost benefit of further increasing the small-issuer threshold and providing this simple break to smaller issuers.

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<sup>1</sup> See Revenue Rulings 54-296, 57-187, 59-41, and 60-248, and Revenue Procedures 63-20 and 82-26 for descriptions of on behalf of issuers.

<sup>2</sup> §1.148-8(d)(1) of the Treasury

Regulations provides that in the case of a pooled financing issue, the pool lender is subject to rebate only on "unloaned gross proceeds".

<sup>3</sup> An entity possessing substantial taxing, eminent domain, and police powers is not treated as a controlled entity (e.g., a city is not controlled by the state).

<sup>4</sup> If the refunded bonds were issued before the effective date of the Tax Reform Act of 1986 and, therefore, were not subject to rebate, this requirement is generally met if such refunded bonds would have been rebate-exempt small issues had the Tax Reform Act of 1986 applied.

<sup>5</sup> If the maturity of the original new money bond was 3 years or less, the average maturity date

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requirement will not apply.

<sup>6</sup> §1.148-9(e)(2) of the Treasury Regulations provides that the multi-purpose issue allocation rules of Section 1.148-9(h), pertaining to refunding bonds, applies for purposes of this allocation.

<sup>7</sup> For example, most new high school facilities cost well in excess of \$5 million and, therefore, many relatively small school districts exceed this limitation when financing such facilities.