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SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS: THE GROWING ABUSE

Section 103(a)(1) of the Internal Revenue Code of 1954¹ (I.R.C.) exempts the interest paid on obligations of states and their political subdivisions from federal income taxation.² Section 103(b)³ similarly exempts the interest on certain industrial development bonds (IDBs).⁴ IDBs are a device that states and municipalities employ to induce private industry to locate in a particular area.⁵ Typically, a state or political subdivision issues an IDB under the name of the state or subdivision and makes the proceeds available to a selected private business for quasi-public or private ventures.⁶ The IDBs normally are backed only by the

¹ I.R.C. § 103(a)(1).

² *Id.* Under I.R.C. § 103(a)(1), obligations of a state or its political subdivisions, a territory, or the District of Columbia are not taxable insofar as gross income does not include the interest paid on the obligations. *See id.* Gross income does not include interest on the obligations except as §§ 103(c) & (d) provide. *See* Treas. Reg. § 1.103-1 (1972). In the Tax Reform Act of 1976, Congress redesignated § 103(c) so that the current subsection is labeled 103(b). *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 190 (1976).

Whether an investor prefers taxable or tax-free investments depends foremost on his marginal tax rate. *See* 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, 1658 (1972) [hereinafter cited as *Limited Tax-Exempt Status*].

³ I.R.C. § 103(b).

⁴ *See id.* (4)-(7); text accompanying notes 17-19 *infra*.

⁵ *See, e.g.*, CONGRESSIONAL BUDGET OFFICE, SMALL ISSUE INDUSTRIAL REVENUE BONDS at xii (1981) [hereinafter cited as SMALL ISSUE]; Doyle, *Recent Rulings on Tax-Exempt Financing Highlight Restrictive IRS Positions*, 58 TAXES 175, 175 (1980); Note, *State and Local Industrial Location Incentives—A Well Stocked Candy Store*, 5 J. CORP. L. 517, 532 (1980) [hereinafter cited as *Industrial Location Incentives*]; text accompanying notes 76-78 *infra*. Many state constitutions contain express prohibitions against lending the states' credit for private purposes. *See, e.g.*, FLA. CONST. art. 7, § 10; IDAHO CONST. art. 8, § 2; N.C. CONST. art. V, § 4; VA. CONST. art. 10, § 10; Comment, *Revenue Bonds Financing Home Mortgages: Can This Governmental Role Overcome Constitutional and Pragmatic Obstacles*, 12 TOL. L. REV. 429, 434 (1981) [hereinafter cited as *Constitutional and Pragmatic Obstacles*] (compilation of state constitutional credit clauses). To avoid any constitutional attack, however, many states have enacted constitutional amendments specifically authorizing IDB financing. *See, e.g.*, LA. CONST. art. 14, § 14 (authorizing municipalities to issue IDB's); ME. CONST. art. IX, § 8 (municipality permitted to issue IDBs when authorized by majority of registered voters); NEB. CONST. art. IX, § 16 (authorizing local units to issue IDBs); OHIO CONST. art. VIII, § 13 (IDB financing in public purpose). *See generally* Mitchell v. North Carolina Indus. Dev. Fin. Auth., 273 N.C. 137, 143-50, 159 S.E.2d 745, 753-60 (1968) (discussion of constitutional provisions); text accompanying notes 6 & 111-19 *infra*.

⁶ *See* H. HUNKER, INDUSTRIAL DEVELOPMENT 163 (1974) [hereinafter cited as H. HUNKER]; SUBCOMM. ON OVERSIGHT OF THE COMM. ON WAYS AND MEANS, 97TH CONG., 1ST SESS., REPORT ON TAX-EXEMPT "SMALL ISSUE" INDUSTRIAL REVENUE BONDS 1 (Comm. Print 1981) [hereinafter cited as SUBCOMM. REPORT]. Financing private projects with IDBs typically begins with the governmental issuance of the bonds. *See Constitutional and Pragmatic Obstacles, supra* note 5, at 436. The governmental borrower uses the bond proceeds to con-

credit of the private business.⁷ If the IDB qualifies as tax-exempt, the selected business receives the equivalent of a low-interest loan as a direct result of the section 103(b) tax exemption.⁸

Originally, all IDBs were tax-exempt.⁹ The purpose of the tax exemption was to encourage investment in small industries.¹⁰ The growth in IDB volume and abuse of the IDB tax exemption by large corporations in the 1960s, however, led Congress to repeal the tax exemption of virtually all IDBs. Congress continued to allow the tax exemption for certain activities¹² and for "small issues" under certain dollar amounts.¹³ Despite

struct the desired facility. *See id.* The governmental unit or authority then rents the facility to the private concern at a rate which equals the total obligation owed to the bondholders. *See id.* After the private concern has satisfied all obligations of the IDB, the issuing authority normally either sells the facility to the private concern at a nominal cost or continues to rent the facilities to the private concern. *See id.*; notes 32 & 84 *infra*.

⁷ *See* R. PRICE, ABC'S OF INDUSTRIAL DEVELOPMENT BONDS 1 (1981) [hereinafter cited as R. PRICE]. If the private IDB user defaults on the bond payments, the governmental issuer's credit is unaffected. *See id.*

⁸ *See* SUBCOMM. REPORT, *supra* note 6, at 1. IDB's typically finance privately-owned projects. The private user desiring tax-exempt financing often has no choice but to employ IDB financing, structuring the issue so as to gain tax-exempt status either through the small issue IDB or through an exempt activity IDB. *See Constitutional and Pragmatic Obstacles, supra* note 5, at 436; text accompanying notes 12-13 *infra*. The advantage of IDB financing to a small company without other financing options is that the small company can start up or expand the business without having to absorb the high initial investment in construction. *See id.* Assuming that a tax-exempt IDB pays three percent less annually in interest than a taxable bond, for example, a business financing with a \$10 million twenty-year small issue IDB would save \$6 million in interest over the period of the bond. *See Industrial Location Incentives, supra* note 5, at 536; text accompanying note 6 *supra* & note 54 *infra*.

⁹ *See* SMALL ISSUE, *supra* note 5, at xvi.

¹⁰ *See id.*; text accompanying notes 17 & 57-61 *infra*.

¹¹ *See* The Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, § 107, 82 Stat. 267 (1968) (amending I.R.C. § 103, adding subsection (c)) [hereinafter cited as 1968 Act]; *Industrial Location Incentives, supra* note 5, at 543; note 2 *supra*. The estimated average size of IDBs at the time of the 1968 Act was \$8,500,000. *See Industrial Location Incentives, supra* note 5, at 543; note 19 *infra*.

¹² *See* I.R.C. § 103(b)(4). The 1968 Act provided exceptions to the rule that interest on IDBs would be taxable. *See id.* If substantially all of the proceeds of the IDB finance either acquisition of residential real property for family units, sports facilities, convention or trade show facilities, airports, wharves, mass-commuting facilities, parking facilities, certain training facilities, sewage or solid waste control facilities, air or water pollution control facilities, or the purchase of land for industrial parks, then the investor in the IDB would not lose his tax-exempt status. *See id.*; text accompanying notes 31 & 41 *infra*.

¹³ *See* I.R.C. § 13(b)(5). Bonds issued as part of an issue of \$1 million or less, labeled small issues, remained tax exempt after the 1968 Act. *See id.*; text accompanying notes 32-35 *infra*. With the \$1 million restriction imposed, the 1968 Act severely hampered use of the IDB's as an industrial location incentive. *See Industrial Location Incentives, supra* note 5, at 543; text accompanying notes 53 *infra*.

Today, forty-seven states have enabling legislation permitting the use of small issues, although some states are more restrictive than others. *See* SMALL ISSUE, *supra* note 5, at xii & 71; text accompanying notes 111-19 *infra*. The District of Columbia, Hawaii, Idaho and Washington do not allow small issue IDBs. *See* SMALL ISSUE, *supra* note 5, at 71; notes 111-15 *infra*. Some form of IDB is available in all fifty states. *See Industrial Location Incen-*

congressional reform, large commercial enterprises continue to qualify for tax-exempt small issue IDBs.¹⁴ One reason for the ability of large businesses to abuse small issue IDBs stems from ambiguous language in section 103(b).¹⁵ More importantly, current abuse of the tax exemption of IDBs results from the liberalization of state IDB enabling laws.¹⁶

The original purpose of the IDB tax exemption was to aid small industry and to reduce the level of unemployment in economically distressed areas.¹⁷ From the inception of IDB financing in 1936¹⁸ until 1968, the number of large companies using IDBs alarmed Congress and the Treasury.¹⁹ Opponents of IDB financing argued that the tax-exempt

tives, *supra* note 5, at 534 & 673-674 (1980) (Appendices III-V) (complete collection of states' IDB enabling statutes); text accompanying notes 111-19 *infra*.

¹⁴ See SMALL ISSUE, *supra* note 5, at 4 (IDBs for national retail furniture chain, national fast food restaurant, private golf course and country club). In Pennsylvania and Minnesota, commercial projects now outnumber the original and common industrial uses of IDBs. See *id.* at 18. Other increasingly common commercial uses of IDBs include financing of grocery stores, automobile dealerships, ice cream parlors, bowling alleys, beach resorts, skating rinks, for-profit hospitals and nursing homes, bank branches, office buildings and ski resorts. See *id.* at 18-19; *Hearings Before the Subcomm. on Oversight of the Comm. on Ways and Means*, 97th Cong., 1st Sess., 224-231 (1981) (statement of Jay Angoff, Public Citizen's Congress Watch) (IDB financing of adult bookstores) [hereinafter cited as *Subcomm. Hearings*]; text accompanying notes 57-61 *infra*.

¹⁵ See text accompanying notes 62-74 *infra*.

¹⁶ See text accompanying notes 75-79 *infra*.

¹⁷ See, e.g., 114 CONG. REC. 30603 (1968) (statement of Rep. Mills); *Proposed Legislation Relating to Amendment of Internal Revenue Code: Hearings on H.R. 15414 Before the Senate Committee on Finance*, 90th Cong., 2d Sess. 82 (1968) (statement of Ribicoff) [hereinafter cited as *Senate Hearings on H.R. 15414*]; *Industrial Location Incentives*, *supra* note 5, at 540; *Limited Tax-Exempt Status*, *supra* note 2, at 1654; SMALL ISSUE, *supra* note 5, at xiv, 10 & 12; note 43 *infra*.

¹⁸ See SMALL ISSUE, *supra* note 4, at 7. Mississippi in 1936 was the first state to authorize tax-exempt IDB financing. See *id.* Two years later, the Mississippi Supreme Court upheld the IDB's enabling act. See *Albritton v. City of Winona*, 181 Miss. 75, ___, 178 So. 799, 810 (as a question of state law), *appeal dismissed per curiam*, 303 U.S. 627 (1938). Mississippi's "Balance Agriculture With Industry Program" authorized municipalities to acquire land and construct facilities for commercial, industrial, agricultural, and manufacturing purposes. See Miss. Laws. 1st Extraord. Sess. 1936; Miss. CODE ANN. §§ 57-1-1-51 (1972 & Cum. Supp. 1979). Municipalities would then lease these enterprises, assuming both a state board and the electorate of the municipalities first approved the project. See Note, *The "Public Purpose" of Municipal Financing for Industrial Development*, 70 YALE L.J. 789, 790 (1961) [hereinafter cited as *Public Purpose*]. The *Albritton* court approved the plan. 181 Miss. at ___, 178 So. at 810; see SMALL ISSUE, *supra* note 5, at 7. By dismissing the appeal of the decision for lack of a substantial federal question, the United States Supreme Court narrowly restricted federal court review of the policies underlying IDB financing. See 303 U.S. at 627; *Industrial Location Incentives*, *supra* note 5, at 528; note 81 *infra*.

¹⁹ See, e.g., 114 CONG. REC. 909 (1968) (Treasury Department Memorandum) (increase of IDBs in the 1960's); 114 CONG. REC. 8147 (1968) (comments of Sen. Ribicoff) (flood of IDBs); 114 CONG. REC. 8152 (comments of Sen. Proxmire) (IDBs in great number); SMALL ISSUE, *supra* note 5, at 2 & 7-9; Hellige, *Industrial Development Bonds: The Disclosure Dilemma*, 6 J. CORP. L. 291, 300 (1981) [hereinafter cited as Hellige]; *Industrial Location Incentives*,

status of IDBs caused a significant erosion of the federal tax base.²⁰ More importantly, opponents argued that IDB financing created pressures in the municipal bond market by increasing competition for funds normally used for conventional municipal projects such as road building or schools.²¹

supra note 5, at 541-545; *Limited Tax-Exempt Status*, *supra* note 2, at 1651-1652 (debate ensued seeking best method to remove tax-exempt status of IDBs while preserving tax-exempt status for more conventional municipal bonds). In 1956, bond issuers publicly placed twenty-four IDB issues averaging \$267,000 per issue. *See* 114 CONG. REC. 909 (1968) (Treasury Department Memorandum); *Limited Tax-Exempt Status*, *supra* note 2, at 1651. By 1967, the number of issues per year increased to 133 averaging \$3,700,000 per issue. *See* 114 CONG. REC. 909 (1968) (Treasury Department Memorandum); *Limited Tax-Exempt Status*, *supra* note 2, at 1651. The annual volume of IDBs from 1960 to 1968 rose from \$100 million to \$1.8 billion. *See* SMALL ISSUE, *supra* note 5, at 8 (reported sales only); note 11 *supra* and note 51 *infra*. In 1968 the Treasury Department was reconsidering its position on the tax-exempt status of interest paid on IDBs because the real debtor of the IDB was the private corporation and not the governmental authority. *See* Treasury Department, *Technical Information Release No. 972* (March 6, 1968) (TIR 972); I. COHEN, MUNICIPAL BOND PROBLEMS 80 (1969) [hereinafter cited as I. COHEN]; *Senate Hearings on H.R. 15414*, *supra* note 17, at 94-95 (reprint of TIR 972). On March 23, 1968, the Internal Revenue Service (I.R.S.) published Proposed Regulation § 1.103-7 which would have removed the IDB from treatment as an obligation of the state or other governmental unit under § 103, thereby subjecting the interest on all IDBs to tax. *See* I. COHEN, *supra* at 81. On May 15, 1968, the I.R.S. indefinitely postponed the hearings on the proposed regulation because Congress was considering legislation for IDBs. *See id.* at 81. The I.R.S. later withdrew the proposed regulation after the passage of the Revenue and Expenditure Control Act of 1968. *See id.* at 83-84; text accompanying notes 22-28 *infra*.

²⁰ *See Limited Tax-Exempt Status*, *supra* note 2, at 1651-55; text accompanying note 52 *infra*. The Treasury Department estimated that in 1968, for a taxpayer in the 50% tax bracket, the Treasury lost an average of \$2.28 on each \$100 of capital invested in IDBs. *See Senate Hearings on H.R. 15414*, *supra* note 17, at 114-15; note 52 *infra*. Moreover the IDB tax exemption is regressive insofar as the taxpayer with a higher marginal tax rate saves more by investing in IDB's than does another taxpayer in a lower tax bracket. *See Limited Tax-Exempt Status*, *supra* note 2, at 1652; note 51 *infra*. Tax-exempt IDB's, therefore, are a potential tax haven for high-income individuals. *See Limited Tax-Exempt Status*, *supra* note 2, at 1654; note 51 *infra*.

²¹ *See, e.g., Industrial Location Incentives*, *supra* note 2, at 1654; SMALL ISSUES, *supra* note 5, at 9. The general obligation bond, traditionally the predominant form of municipal financing, competes for the same funds as IDB's. *See* Greenberg, *Municipal Securities: Some Basic Principles and Practices*, 9 URB. LAW. 338, 340 (1977) [hereinafter cited as Greenberg]. The "full faith and credit" of the issuing governmental authority backs the general obligation bond, and normally either *ad valorem* property tax, income tax or sales tax revenues secure the bonds. *See id.*; text accompanying note 131 *infra*. Other types of long-term municipal bonds include limited guarantee bonds, special tax bonds and revenue bonds. *See* Greenberg, *supra* at 341.

Increased investment in exempt IDB's results in a reduction of the supply of money available for true municipal purposes. *See, e.g., Senate Hearings on H.R. 15414*, *supra* note 17, at 81-82 (statement of Sen. Ribicoff) (IDBs' effect on interest rates poses a serious threat to state and local borrowing ability) (cost of local government rises as more tax-exempt bonds are issued); 114 CONG. REC. 26414 (1968) (comments of Sen. Ribicoff) (IDBs put upward pressure on interest rates); 114 CONG. REC. 26415 (1968) (comments of Sen. Proxmire) (IDBs create disruption in the market for legitimate obligations of state and local governments); *Public Purpose*, *supra* note 18, at 793; note 51 *infra*. The reduced money supply forces a

To counteract the disturbing increase in IDB investment and to retard widespread abuse of the municipal bond tax exemption,²² Congress enacted the Revenue and Expenditure Control Act of 1968 (1968 Act).²³ The 1968 Act eliminated the tax-exempt status of IDBs with certain exceptions.²⁴ Section 103(a)(1) provides a tax exemption for all obligations of states and their political subdivisions.²⁵ Section 103(b)(1) denies IDBs the section 103(a)(1) tax exemption.²⁶ Section 103(b), however, provides exceptions which preserve the tax-exempt status of certain IDBs.²⁷ Unless the IDB qualifies as an exception to the rule of Section 103(b)(1), the interest earned from an IDB is taxable.²⁸ Therefore, the first inquiry in determining whether an obligation is tax-exempt under section 103(b) is whether the obligation is an IDB.²⁹ If the obligation is an IDB, the next inquiry is whether the IDB qualifies as an exception to section 103(b)(1).³⁰

One of the exceptions to section 103(b)(1) includes small issue IDBs as defined in section 103(b)(6).³¹ The other exception includes IDBs to

state or municipality to offer higher interest rates on municipal bonds simply because of supply and demand principles. See text accompanying note 92 *infra*. States and municipalities must then recover the extra interest by increasing state and local taxes. See 114 Cong Rec. 7685 (1968) (editorial submitted by Sen. Nelson) (taxpayer assumes extra burden because of IDB's); *Limited Tax-Exempt Status*, *supra* note 2, at 1654; text accompanying note 115 *infra*. While many people opposed IDBs because of the general abuse of the municipalities tax exemption, others viewed taxation of municipal bond interest an impermissible impairment by the federal government of the state's borrowing power. See *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 584 (tax on municipal bond interest unconstitutional), *vacated on other grounds*, 158 U.S. 601 (1895); *Limited Tax-Exempt Status*, *supra* note 2 at 1652; note 6 *supra*. But see U.S. CONST. amend XIII (congressional power to tax income from whatever source derived); *Helvering v. Gerhardt*, 304 U.S. 405, 424 (1938) (upholding federal tax on state employees' incomes).

²² See note 19 *supra* & text accompanying note 44 *infra*.

²³ See note 11 *supra* & text accompanying note 44 *infra*.

²⁴ See I.R.C. § 103(b)(1) & (4)-(7); notes 12-13 *supra* and notes 31-35 *infra*.

²⁵ See I.R.C. § 103(a)(1); note 2 *supra*.

²⁶ I.R.C. § 103(b)(1).

²⁷ See I.R.C. § 193(b)(4)-(7); notes 12-13 *supra* and notes 31-35 *infra*.

²⁸ See I.R.C. § 103(b)(4)-(7); notes 31-35 *infra*.

²⁹ See I.R.C. 103(b)(2). In order to be an IDB, the bond must meet the statutory requirements on "a major portion" of the bond proceeds and on "a major part" of the security for payment of the "principal or interest". See *id.*; text accompanying note 32 *infra*.

³⁰ See note 29 *supra* and text accompanying notes 31-35 *infra*. In order for the IDB to be tax-exempt, the IDB must meet the statutory requirement that "substantially all" of the proceeds be used in a specific manner. See I.R.C. 103(b)(6).

³¹ See I.R.C. § 103(b)(4)-(7). The rule that IDB's are taxable does not apply when substantially all of the proceeds finance an "exempt activity". See *id.* (b)(4). Exempt activities include, among others, low income residential projects, mass commuting facilities, or air or water pollution control facilities. See *id.*; note 12 *supra*. See also Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 811(a) & 812(a) (1981) (enactment of § 103(b)(4)(I), adding qualified mass commuting facilities to § 103(b)(4)) (enactment of § 103(i), adding volunteer fire departments as a political subdivision of state); Crude Oil Windfall Profits Tax Act of 1980, Pub. L. No. 96-223, § 242(a)(1)(1980) (enactment of § 103(g), adding qualified

finance certain exempt activities such as parking facilities, airports, and pollution-control facilities.³² Section 103(b)(6) exempts small issues from

steam-generating and alcohol-producing facilities to § 103(b)(4); Committee on Tax Exempt Financing, *Legislative Changes*, 33 TAX LAW. 1490, 1490 (1979-1980); note 12 *supra*. Additionally, the rule that IDB's are taxable does not apply to bonds financing the acquisition of land for industrial parks, financing hydroelectric generating facilities or financing qualified public facilities, which are facilities listed 103(b)(4)(C) & (D) and generally available to the public. See I.R.C. § 103(b)(5) & (b)(7)-(8).

³² See I.R.C. § 103(b)(6); note 13 *supra*. For a bond to qualify as a small issue, the obligation first must be an IDB. See I.R.C. § 103(b)(6); text accompanying note 29 *supra*. An IDB as opposed to another form of municipal bond, must satisfy the "trade or business test" and the "security interest test". See I.R.C. § 103(b)(2)(A)-(B); text accompanying notes 63-69 *infra*. The trade or business test requires the beneficiary of the bond's proceeds (user) to apply "a major portion" of the bond's proceeds either directly or indirectly in any trade or business which non-exempt persons conduct. See I.R.C. § 103(b)(2)(A) & (B); Treas. Reg. § 1.103-7(b)(3) (1972); Kirkpatrick v. United States, 605 F.2d 1160 (10th Cir. 1979), *cert. denied*, 444 U.S. 1075 (1980) (indirect use of bond proceeds rendered bonds IDBs under trade or business test); text accompanying notes 63-68 *infra*. An exempt person is a governmental unit or a tax-exempt organization under I.R.C. § 501(c)(3), typically a corporation organized and operated exclusively for religious, charitable, scientific or educational purposes. See I.R.C. § 103(b)(3)(A)-(B); *id.* § 501(c)(3).

The security interest test examines both the source for the payment of the principal or interest and the type of security provided for the payment. See Treas. Reg. § 1.103-7(b)(4) (1972). The test requires the user to provide security for payment of at least "a major part" of the principal or interest. See I.R.C. § 103(b)(2)(B)(i); text accompanying notes 63-68 *infra*. To determine the nature and source of security for payment of an IDB, the Treasury examines the terms of the bond and all the underlying arrangements. See I.R.C. § 103(b)(2)(B)(ii). If the obligor of the bond pledges property as security for the payment of the bond, the property need not be property financed by the proceeds of the bond in question. See *id.*

If an obligation fails either the trade or business test or the security interest test, the obligation is not taxable under § 103(b). See I.R.C. § 103(b)(4)-(7). But unless the bond qualifies for another exemption, such as the § 103(a)(1) tax exemption for states and their political subdivisions, the interest earned on the bond is taxable. See *id.* (b)(4)-(7); 605 F.2d at 1163; text accompanying note 25 *supra*. Alternatively, if the user satisfies both tests the bond is an IDB, and the IDB is tax-exempt only if it qualifies as a small issue under § 103(b)(6) or if the proceeds of the IDB finance an exempt activity provided by §§ 103(b)(4)-(5) or 103(b)(7)-(8). See I.R.C. § 103(b)(4)-(8); text accompanying notes 12-13 *supra* & notes 33-39 *infra*.

Other requirements for the small issue and exempt activities IDBs include the "substantially all" test, which requires the user to expend substantially all of the bond proceeds for the purposes which § 103(b) requires. See I.R.C. § 103(b)(4)-(7); Treas. Reg. §§ 1.103-8(a)(1) -10(b)(1)(ii) (1980); text accompanying notes 33 & 71-73 *infra*. Further, to classify an IDB project as an exempt activity (exempt facility), the IDB must meet both "public use" and "official action" requirements. See Treas. Reg. §§ 1.103-8(a)(2) & -(5)(ii)-(iv) (1980). Before construction of an exempt facility, the issuer should have a bond resolution adopted or should take other official action to determine whether the bond qualifies as an exempt facility under § 103(b). See Treas. Reg. § 1.103-8(a)(5)(ii)-(iv) (1980); R. PRICE, *supra* note 7, at 16; note 85 *infra*. The public use requirement generally demands that the user of the tax-exempt facility directly serve the public. See Treas. Reg. § 1.103-8(a)(2) (1980); Rev. Rul. 76-494, 1976-51 I.R.B. 7; Roberts, *Industrial Development Bond Financing: Section 103(b) Examined*, 32 U. FLA. L. REV. 1, 20-21 (Tax 1979) [hereinafter cited as Roberts]. The I.R.S. recently announced that small issues also must meet official action requirements, yet small issues

tax regardless of the use of the proceeds of the issue³³ if the aggregate authorized face amount of the bond is \$1 million or less.³⁴ Another form of small issue includes obligations of \$10 million or less if the \$10 million includes certain capital expenditures incurred during a specified six-year period.³⁵

have no public purpose requirements. See Treas. Reg. §§ 1.103-8(a)(5) & -10(b)(1)(ii) (1980); R. PRICE, *supra* note 7, at 16; Roberts, *supra* at 21; text accompanying notes 33-34 *infra*. Finally, an otherwise tax-exempt IDB is taxable while the IDB is held by a substantial user of the facilities. See I.R.C. § 103(b)(10); Treas. Reg. § 1.103-11 (1972) (substantial user is non-exempt person deriving more than 5% of total IDB revenue or occupying more than 5% of the exempt facility's usable area); R. PRICE, *supra* note 7, at 22.

³³ See I.R.C. § 103(b)(6)(A). Although § 103(b)(6) does not generally restrict the use of proceeds from tax-exempt small issues, substantially all of the bond proceeds must provide for the acquisition, construction or improvement of depreciable land or property. See I.R.C. § 103(b)(6)(A)(i). See also note 59 *infra*. Alternatively, the small issue proceeds may finance the redemption of part or all of a prior issue if the prior issue meets the requirements of § 103(b)(6). See I.R.C. § 103(b)(6)(A)(ii). A prior issue will not satisfy the § 103(b)(6) requirements unless substantially all of the prior issue's proceeds provide for the acquisition, construction or improvement of depreciable land or property. See I.R.C. § 103(b)(6)(A)(ii); note 32 *supra* & notes 34-35 *infra*.

³⁴ I.R.C. § 103(b)(6)(A). Adding the face amount of the bond issue with the outstanding face amount of certain prior issues determines the aggregate authorized face amount of the IDB. See I.R.C. § 103(b)(6)(B); Treas. Reg. §§ 1.103-10(b)(1)(i) & -10(d)(2)(i) (1977). The issuer must employ two principal tests to determine which prior issues the issuer should include in the aggregate face amount of the \$1 million IDB. See I.R.C. § 103(b)(6)(B)(i)-(ii); Treas. Reg. § 1.103-10(d)(2)(i)-(iii) (1977); Roberts, *supra* note 32, at 31-42. If the facility financed from the prior exempt small issue is located either in the same incorporated municipality or in the same county as is the project financed by the IDB in question, then the "jurisdictional test" requires inclusion of the outstanding amount of the prior issue in the aggregate face amount of the IDB, provided the "principal user test" also is satisfied. See I.R.C. § 103(b)(6)(B)(i); Treas. Reg. § 1.103-10(d)(2)(i) (1977); Roberts, *supra* note 32, at 32; note 59 *infra*. To satisfy the principal user test, the principal user of a facility financed by a prior exempt small issue must be the same person as, or a related person to the principal user of the project financed by the IDB in question. See I.R.C. § 103(b)(6)(B)(i); Treas. Reg. § 1.103-10(d)(2)(ii); Roberts, *supra* note 32, at 35-36; note 74 *infra*. See also I.R.C. § 103(b)(6)(C) (definition of related person); Treas. Reg. § 1.103-10(e) (1977) (same).

³⁵ See I.R.C. § 103(b)(6)(D). Although the \$1 million small issue remains intact with no capital expenditure requirements, an issuer electing certain capital expenditure restrictions may issue a \$10 million IDB. See *id.*; Treas. Reg. 1.103-10(b)(2)(vi) (1977). See also Pub. L. No. 95-6500, §§ 331-334 (1978) (raising IDB maximum face amount to \$10 million); Pub. L. No. 90-634, § 401 (1968) (amending Pub. L. No. 90-364, § 107) (creating \$5 million IDB); I. COHEN, *supra* note 19, at 73 (outline of 1968 amendments of I.R.C. § 103); Roberts, *supra* note 32, at 1-3 (1968 amendments); notes 57 & 74 *infra*. The issuer of a \$10 million small issue must take into account capital expenditures paid or incurred during the six-year period starting three years before and ending three years after the date of issuance. See I.R.C. § 103(b)(6)(D)(ii); Treas. Reg. § 1.103-10(b)(2)(ii) (1977); note 77 *infra*. To determine whether a capital expenditure is includable in the aggregate face amount of a \$10 million small issue IDB, the issuer must satisfy the jurisdictional test and the principal user test, which are essentially the same tests used for qualifying includable prior issues under the \$1 million limit. See I.R.C. § 103(b)(6)(E); note 34 *supra*. The jurisdictional test requires the issuer to include in the aggregate face amount of the \$10 million IDB only those capital expenditures for facilities located either in the same county or in the same incorporated municipality. See I.R.C. §

The purpose of the creation of the small issue accords with the original purpose of IDBs generally, which is to provide a means for encouraging the expansion of small industries, particularly in economically distressed areas.³⁶ Much of the congressional debate preceding the 1968 Act concerned the use of the IDB tax exemption by large corporations to construct facilities located in large metropolitan areas.³⁷ Congress designed the 1968 Act to eliminate virtually all IDB financing for projects that did not conform to the original purposes of the IDB tax exemption.³⁸ Since large corporations were the primary users of IDBs, few IDBs conformed to the original purposes of the IDB tax exemption.³⁹ The real legislative purpose of the 1968 Act, therefore, was to prevent large corporations from abusing the original purposes of the IDB tax exemption.⁴⁰ By creating the second exception for exempt activity IDBs, Congress promoted socially desirable projects, quasi-public services, and other activities in which state or local governmental units are typically involved.⁴¹ Thus, Congress intended the 1968 Act to eliminate the abuse of the tax-exempt status of IDBs⁴² and to continue the tax exemption for

103(b)(6)(D)(ii)-(E)(i); note 59 *infra*. Under the principal user test, the principal user of a facility is the same person as, or a related person to the principal user of the project financed by the IDB in question. See I.R.C. § 103(b)(6)(D)(ii)-(E)(iii). Therefore, when the issuer has made expenditures with respect to facilities located in the same county or municipality as the IDB project in question, when the issuer is the principal user of the facilities, and when the issuer has made the expenditures within the statutory six-year period, then the expenditures are capital expenditures includable in the aggregate \$10 million maximum face amount of the IDB. See I.R.C. § 103(b)(6)(D)-(E); Roberts, *supra* note 32, at 43.

³⁶ See Note, *The Importance of Assessing Business Transactions for Their Impact Upon the Tax-Exempt Status of Industrial Development Bonds*, 30 SYRACUSE L. REV. 705, 713 (1979) [hereinafter cited as *Impact Upon The Tax-Exempt Status*]; *Limited Tax-Exempt Status*, *supra* note 2, at 1656, 1660; text accompanying note 17 *supra*.

³⁷ See, e.g., 114 CONG. REC. 7681 (1968) (statement of Sen. Proxmire); 114 CONG. REC. 7693-7701 (1968) (compilation of all Mississippi IDB's 1938-1967 including size data); 114 CONG. REC. 7701-7702 (1968) (statement of Sen. Scott); *Limited Tax-Exempt Status*, *supra* note 2, at 1654; SMALL ISSUE, *supra* note 5, at 9.

³⁸ See, e.g., 114 CONG. REC. 26414 (1968) (statement of Sen. Ribicoff); 114 CONG. REC. 26417 (1968) (statement of Sen. Baker); 114 CONG. REC. 26416 (1968) (statement of Sen. Curtis); 114 CONG. REC. 26417-26418 (1968) (editorial submitted by Sen. Baker); text accompanying note 17 *supra*.

³⁹ See text accompanying note 46 *infra*.

⁴⁰ See generally notes 17 & 38 *supra*.

⁴¹ See, e.g., Roberts, *supra* note 32, at 12-13; *Impact Upon The Tax-Exempt Status*, *supra* note 36, at 712; *Limited Tax-Exempt Status*, *supra* note 2, at 1656; SMALL ISSUE, *supra* note 5, at 2; note 12 *supra*. Congress apparently desired the exempt activities exception of § 103(b) to encourage private industry to assist in providing certain public activities. See *Limited Tax-Exempt Status*, *supra* note 2, at 1656; note 12 *supra*. IDB's used to finance public activities are sufficiently analogous to conventional municipal bonds to warrant tax treatment identical to that of ordinary municipals. See *Limited Tax-Exempt Status*, *supra* note 2, at 1656. The exempt activities covered in § 103(b) resemble typical state or local government activities. See Roberts, *supra* note 32, at 12-13. If the governmental unit or authority itself engages in the activity directly, the interest from the bond probably is tax-exempt without any exception under § 103(b). See *id.* at 13.

⁴² See text accompanying note 11 *supra*.

IDBs when used for purposes which Congress found particularly suitable.⁴³

The 1968 Act resulted in near total eradication of tax-exempt IDBs.⁴⁴ Initially following the legislation,⁴⁵ small issue IDBs comprised an insignificant part of the total municipal bond market.⁴⁶ The combined volume of both the small issues and the exempt activity issues after the 1968 Act was less than three percent of the volume of all IDBs before the 1968 Act.⁴⁷ The rate of growth of small issues was slow during the early seventies,⁴⁸ yet today the level of small issue IDBs has risen more than

⁴³ See, e.g., CONFERENCE COMM., 90th CONG., 2d SESS., REVENUE AND EXPENDITURE CONTROL ACT OF 1968, EXPLANATION OF THE BILL H.R. 15414 AS AGREED TO IN CONFERENCE 1, 14 (Comm. Print 1968) [hereinafter cited as CONFERENCE COMM., 90th CONG.]; CONFERENCE COMM., 90th CONG., 2d SESS., CONFERENCE REPORT ON REVENUE AND EXPENDITURE CONTROL ACT OF 1968, STATEMENT OF THE MANAGERS 32-33 (Comm. Print 1968) [hereinafter cited as STATEMENT OF THE MANAGERS]; *Impact Upon The Tax-Exempt Status*, supra note 36, at 712-713; *Limited Tax-Exempt Status*, supra note 2, at 1655-1656; text accompanying notes 31-32 supra. I.R.C. § 103(b) represents a compromise to eliminate the unfavorable aspects of IDB practice, evidenced by the over-use of IDBs by large corporations, and to preserve the assistance to small industries in economically undeveloped areas. See *Limited Tax-Exempt Status*, supra note 2, at 1655-1656; *Impact On The Tax-Exempt Status*, supra note 36, at 713. See also SMALL ISSUE, supra note 5, at 2; CONFERENCE COMM., 90th CONG., supra at 1 & 14-18. During the congressional debates preceding the 1968 Act, opponents of the tax exemption of IDBs contended that one of the original purposes of IDB financing was to promote the development of rural communities. See 114 CONG. REC. 7685 (1968) (editorial submitted by Sen. Proxmire); *Limited Tax-Exempt Status*, supra note 2, at 1654; text accompanying note 17 supra. Since IDBs were not targeted to any one type of area, the opponents argued that IDB financing encouraged pirating of firms away from an economically distressed area, thereby defeating the original purpose of IDB financing. See *Limited Tax-Exempt Status*, supra note 2, at 1654-1655; text accompanying notes 17-24 supra & note 122 infra.

⁴⁴ See CONFERENCE COMM., 90th CONG., supra note 43, at 14; I. COHEN, supra note 19, at 82 (senate version of H.R. 15414 removing tax-exempt status from all IDBs); Hellige, supra note 19, at 300; *Industrial Location Incentives*, supra note 5, at 335 and 543 (97% drop in tax-exempt IDB volume from 1968 to 1969); *Impact Upon The Tax-Exempt Status*, supra note 36, at 712; text accompanying notes 45-47 infra.

⁴⁵ See Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, § 107(a) (1968); text accompanying notes 11 & 22-23 supra.

⁴⁶ See *Industrial Location Incentives*, supra note 5, at 535; note 47 infra.

⁴⁷ See *Industrial Location Incentives*, supra note 5, at 535. In 1967, tax-exempt IDBs constituted approximately 9% of the total long-term tax-exempt municipal bond market. See SMALL ISSUE, supra note 5, at 9. See also *Limited Tax-Exempt Status*, supra note 2, at 1651 (1967 volume of IDB sales estimated at \$1.3 billion). The 1968 Act reduced IDB volume by 97%, from an estimated \$1.8 billion before the 1968 Act to \$51 million following the 1968 Act. See *Industrial Location Incentives*, supra note 5, at 535; text accompanying note 46 supra. By extrapolation, 97% reduction of the 9% share of the municipal bond market implies that the volume of all tax-exempt IDBs just after the 1968 Act was slightly more than 1/10th of 1% of the market share. See note 51 infra. See generally SMALL ISSUE, supra note 5, at 8-12. This amount reflects the volume of small issues and the issues for the remaining exempt activities. Thus, for small issues alone, the market share would be even less than 1/10th of 1% of the market share. See *id.*

⁴⁸ See SMALL ISSUE, supra note 5, at 12. The slow growth of small issues continued even after Congress amended the definition of small issues to include \$5 million issues if the issuer accounted for certain capital expenditures and prior issues when calculating the \$5

160-fold since 1968, a result Congress neither intended nor foresaw.⁴⁹ The estimated annual volume of small issues alone exceeds \$8.4 billion.⁵⁰ Even accounting for inflation, the increase of IDB use far exceeds the alarming IDB levels reached before the 1968 Act.⁵¹ The concern before the 1968 Act that IDBs erode the federal tax base still exists, and the Congressional Budget Office (CBO) has estimated the loss from IDBs of fiscal year 1981 revenue at over \$1 billion.⁵²

In view of the increasing popularity of IDB financing, the question arises how effective IDBs are in attracting and creating industries which will alleviate unemployment and promote the economy. Industrial location specialists conclude that the availability of IDB financing is not determinative in locating a project.⁵³ Also, in labor-intensive industries

million. See Pub. L. 90-364, § 401 (1968); note 35 *supra*. Although small issue volume grew slowly, the volume of exempt activities grew rapidly in the early seventies. See *Limited Tax-Exempt Status*, *supra* note 2, at 1662. See also *Industrial Location Incentives*, *supra* note 5, at 535 & 543 (explosive growth since 1977 of pollution bonds as exempt activity IDBs).

⁴⁹ See SMALL ISSUE, *supra* note 5, at 12-13; *Industrial Location Incentives*, *supra* note 5, at 535. An increase from \$51 million in volume of all IDB's following the 1968 Act to at least \$8.4 billion today of small issues alone represents an increase of 16,471%, or an approximate 165-fold increase. See note 47-48 *supra*; text accompanying note 51 *supra*.

⁵⁰ See SMALL ISSUE, *supra* note 5, at 14.

⁵¹ See *Id.*, *supra* note 5, at 12-13. Although IDBs offered for public sale usually are reported to the *Daily Bond Buyer*, bonds of smaller companies are often privately placed, and therefore the only records appear in the county clerk's office or in the minutes of the local issuing agency's meetings. See *id.* at 13. Accordingly, IDB use since 1968 has been understated significantly, and measuring the volume of small issues today with any precision is virtually impossible. See *id.*

One result of the 1968 Act increasing IDB sales volumes rather than decreasing volumes as expected was to make IDBs less regressive. See note 20 *supra*. When the volume of municipal bonds including IDBs increases, the market pressure forces interest rates up in the tax-free municipal bond market. See *Limited Tax-Exempt Status*, *supra* note 2, at 1659; note 20 *supra*. As the interest rate rises, the discount between yields on taxable and tax-free bonds shrinks, and more taxpayers with lower marginal tax rates find IDBs and other municipals attractive. See *Limited Tax-Exempt Status*, *supra* note 2, at 1659; note 2 *supra*. Thus, rather than eliminate the tax haven for high marginal rate taxpayers, the 1968 Act has widened an arguable tax loophole to include low marginal rate taxpayers. See *Limited Tax-Exempt Status*, *supra* note 2, at 1659; note 21 *supra*.

⁵² See, e.g., *Industrial Location Incentives*, *supra* note 5, at 542; *Limited Tax-Exempt Status*, *supra* note 2, at 1653-1654; SMALL ISSUE, *supra* note 5, at 9 & 40 (table of projected federal revenue losses from IDBs, 1979-1986); *Senate Hearings on H.R. 15414*, *supra* note 17, at 108-115; note 20 *supra*. The estimated amount of loss from IDBs in revenues to the federal government in 1981 is \$1.038 billion. See SMALL ISSUES, *supra* note 5, at 40. The projected loss from IDBs of federal revenues in 1986 is \$2.880 billion. See *id.* Additionally, since small issues are tax-exempt under most state and local tax laws, including in some states property tax laws, IDBs result in state and local revenue losses. See *id.* at 46.

⁵³ See H. CONWAY, LEGISLATIVE CLIMATE FOR ECONOMIC DEVELOPMENT 27 (1979); GRANT & COMPANY, STUDY OF BUSINESS CLIMATES OF THE FORTY-EIGHT CONTIGUOUS STATES OF AMERICA 3-4 (1979); H. STAFFORD, PRINCIPLES OF INDUSTRIAL FACILITY LOCATION 74 (1979) [hereinafter cited as H. STAFFORD]; *Industrial Location Incentives*, *supra* note 5, at 523 n.34, 545, & 548-49. But see text accompanying note 76 *infra*. In a student survey of two hundred

such as leather, textiles and apparel, industrial location incentive programs which attract industry by providing cheaper capital are capable of overcoming only small differentials in labor costs.⁵⁴ Accordingly, while labor intensive industries would alleviate most effectively unemployment within a state, IDB financing as an industrial location incentive will least benefit the labor-intensive industries and thus will not efficiently alleviate unemployment.⁵⁵ Moreover, while IDB financing occasionally is the deciding factor in choosing one location over another once within a region, IDB financing ranks low in the selection of the region of industrial location.⁵⁶

Although the dollar limits of small issues prevent many larger corporations from using the small issue exception, corporations operating many geographically dispersed, low-cost facilities often use small issues advantageously.⁵⁷ The reason small issues are effective for certain corporations is related to the jurisdictional test for aggregating the total

and sixty firms which had located new facilities within the previous five years, state and local financial incentives ranked sixth on a scale of one to ten as an industrial location incentive, one being the most important factor. *See Industrial Location Incentives, supra* note 5, at 523 n.34. Access to dependable sources of energy, the area's prevailing wage rate, the state's corporate income tax, the supply of skilled labor, and proximity to markets all ranked higher than state or local governmental financial incentives. *See id.* Market accessibility is a major factor affecting the choice of industrial location and is growing at the expense of labor and raw material accessibility. *See H. HUNKER, supra* note 6, at 88. The industrial location incentives ranking lower than the governmental financial incentives were environmental laws and regulations, proximity to materials, stable state personal tax rates, and noneconomic personal considerations. *See Industrial Location Incentives, supra* note 5, at 523. Furthermore, IDB financing ranked third out of four in a choice between location incentives available at the local level. *See id.* at 546 (grouping with general obligation bonds). More favorable as incentives were the extension of sewer and water lines to the plant without direct cost to the firm and a property tax moratorium. *See id.* at 668.

⁵⁴ *See H. STAFFORD, supra* note 53, at 74; *Industrial Location Incentives, supra* note 5, at 547; note 8 *supra*.

⁵⁵ *See Industrial Location Incentives, supra* note 5, at 547.

⁵⁶ *See H. STAFFORD, supra* note 53, at 73-74. *But see* text accompanying note 76 *infra*.

⁵⁷ *See SMALL ISSUE, supra* note 5, at 23; text accompanying notes 14 & 34-35 *supra* & note 82 *infra*. In 1980, K-Mart, the number two retailer in the country, financed 35 stores with small issues. *See SMALL ISSUE, supra* note 5, at 23. Between 1975 and 1980, K-Mart financed 96 stores in 19 states for \$220.5 million of small issue IDBs. *See id.* In 1979, McDonald's used IDBs to open 32 stores just in Pennsylvania and Ohio. *See id.* Kroger, PepsiCo, Nabisco, Proctor and Gamble, General Mills, Burlington Industries, Eckerd Drug Stores and Federated Department Stores are other major retailers, manufacturers and Fortune 500 firms which are taking advantage of small issue IDBs. *See id.* at 23-24.

Approximately half of the Fortune 500 firm small issues are for exactly \$1 million. *See id.* at 24. The CBO explains that for many large corporations which cannot otherwise advantageously use small issues, these corporations employ a \$1 million small issue as part of a larger bond issue. *See id.* The corporation using a large pollution bond, for example, could also use a small issue \$1 million IDB for general expenses. *See id.* Whereas the pollution bond proceeds have restricted uses, § 103(b)(6) requires no specific use of the small issue proceeds, and the corporation might use the \$1 million to purchase equipment, for example, at a lower cost than taxable financing could yield. *See id.*; notes 33-35 *supra*.

face amount of the IDBs.⁵⁸ Provided the facilities financed by each individual small issue IDB are located in different counties or municipalities, section 103(b)(6) does not prevent a corporation from financing with more than one small issue IDB.⁵⁹ Therefore, manufacturers with many small plants, fast food chains and national retailers are particularly suited to finance major expansion programs with small issues.⁶⁰ While other more conventional types of financing are available, large corporations are nonetheless using small issues and abusing the section 103(b)(6) tax exemption since the purpose of small issues was to help small, not large industries.⁶¹

Abuse of small issues also results from inconsistent and ambiguous interpretations of the language in section 103(b).⁶² Section 103(b) sets forth restrictions on both "a major portion" of the bond proceeds used in a trade or business,⁶³ and "a major part" of the security of the bond.⁶⁴ The bond must comply with both restrictions to be an IDB.⁶⁵ The Treasury Department defined a major portion of the proceeds as at least twenty-five percent⁶⁶ and later interpreted a major part to mean a major portion.⁶⁷ Confusion continues to exist, however, with respect to the proper method of calculating the twenty-five percent.⁶⁸ Moreover, when

⁵⁸ See I.R.C. § 103(b)(6)(B)(i); text accompanying notes 59-61 *infra*.

⁵⁹ See I.R.C. § 103(b)(6). Although a company can use small issues in different jurisdictions, the I.R.S. recently eliminated umbrella issues, or multiple IDBs issued simultaneously for projects in different counties or municipalities. See Rev. Rul. 81-216 (1981); *cf.* Proposed Treas. Reg. § 1.103-7(b)(6) & -(c) (Oct. 8, 1981) (superseding Rev. Rul. 81-216) (obligations under § 103(b) are part of same issue if sold at substantially same time, pursuant to common marketing plan, and at substantially same interest rate); R. PRICE, *supra* note 7, at 80-84 (reprint of proposed regulation).

⁶⁰ See note 57 *supra*.

⁶¹ See note 57 *supra* and text accompanying note 36 *supra*.

⁶² See Roberts, *supra* note 32, at 54; notes 63-74 *infra*.

⁶³ See notes 29 & 32 *supra*.

⁶⁴ See notes 29 & 32 *supra*.

⁶⁵ See notes 29 & 32 *supra*.

⁶⁶ See Treas. Reg. § 1.103-7(b)(3)(iii) (1972). When two or more non-exempt persons use IDB proceeds, the aggregate of each person's portion determines whether 25% or more of the proceeds are used in a trade or business. See *id.* If the aggregate is more than 25%, the bond is an IDB, taxable under I.R.C. § 103(b)(1). See *id.*; note 32 *supra*.

⁶⁷ See Treas. Reg. § 1.103-7(b)(1)(ii); note 32 *supra*.

⁶⁸ See Roberts, *supra* note 32, at 6. The Treasury Regulations do not construe consistently "a major portion" of IDB proceeds. One Treasury Regulation example examined only the percentage of floor space used by the non-exempt person to determine whether the "major portion" percentage of the trade or business test was satisfied. See Treas. Reg. § 1.103-7(c), Example (6)(b) (1972); Rev. Rel. 79-282, 1979-39 I.R.B. 8. In another example, the Treasury qualified only the reasonable rental value of the space used by the non-exempt person. See Treas. Reg. § 1.103-7(c), Example (7) (1972). The inconsistency notwithstanding, a possibility of abuse exists in both examples. In the former example, the Treasury in calculating the major portion did not take into account varying costs of different spaces within the same facility. In the latter example, the Treasury ignored the possibility that not all the space within the facility has the same rental value. See Roberts, *supra* note 32, at 6.

defining a major part of the security, the conjunction "or" employed in the term "principal or interest" leads to a confusing result.⁶⁹ The security for at least twenty-five percent of the principal or interest arguably could mean security for twelve and one-half percent of the principal and twelve and one-half percent of the interest, rather than twenty-five percent of the sum of principal plus interest. Section 103(b) and the relevant Treasury Regulations are ambiguous.⁷⁰ The "substantially all" requirement of the small issue and exempt activities IDBs requires substantially all of IDB proceeds to be spent on the IDB project.⁷¹ The Treasury has defined substantially all as ninety percent.⁷² Calculation of ninety percent, however, raises more interpretational problems.⁷³ One example is the case of an IDB user trying to spend proceeds on other than the IDB project, yet manipulating the technical terms to meet the "substantially all" test for tax-exempt purposes.⁷⁴

⁶⁹ See I.R.C. § 103(b)(2)(B); text accompanying notes 70-73 *infra*.

⁷⁰ See I.R.C. § 103(b)(2)(B); Roberts, *supra* note 32, at 10. *But see* Treas. Reg. § 1.103-7(c), Example 6(b) (1972) (bonds are IDBs because security for major part of principal and interest).

⁷¹ See I.R.C. § 103(b)(4)-(7); notes 29 & 32 *supra*.

⁷² See Treas. Reg. § 1.103-8(a)(1)(i) (1980); note 32 *supra*. In 1977, the Treasury amended the ambiguous provisions of the Treasury Regulations to specify that, with regard to exempt activities, "substantially all" requires at least 90 percent. See Treas. Reg. § 1.103-8(a)(1)(i) (1980); Roberts, *supra* note 32, at 13. The Regulation also states that the 90% rule applies to small issues. See Treas. Reg. § 1.103-10(b)(1)(ii) (1977). In calculating 90%, the use of bond proceeds for any purpose other than for the exempt activity or small issue facility reduces pro-rata the amount of the proceeds included in the 90% calculation. See Treas. Reg. §§ 1.103-8(a)(1)(i) & -10(b)(1)(ii). Further, when calculating the amount of proceeds for the substantially all requirement, the borrower may include all amounts paid or incurred which are chargeable to the facility's capital account. See *id.* The borrower may include amounts paid or incurred which could be chargeable either by a taxpayer's proper election or chargeable but for the taxpayer's election to deduct the amounts. See *id.* The Treasury apparently accepts the inclusion for the substantially all requirement of all facility costs regardless of whether deducted or capitalized on the owner's income tax return. See Roberts, *supra* note 32, at 13-14; note 73 *infra*.

⁷³ See Roberts, *supra* note 32, at 14. An ambiguous result is possible when calculating the substantially all requirement necessary for an IDB to be tax-exempt. See *id.*; note 32 *supra*. Assume, for example, working capital totals \$150 thousand of a \$2 million bond issue, and the qualifying costs total exactly 90% of the bond issue. See *id.* If the interest earned on the IDB proceeds during the period of construction is \$200 thousand and is expended for qualifying costs, the percentage of the IDB proceeds used for the exempt activity is 91.2%. See *id.* at 15 n.70. If, however, this interest earned is used as additional working capital, a nonqualifying cost, then the percentage is 79.4%. See *id.* Thus, in the latter case, the substantially all requirement would not be met, and the IDB would be taxable. See *id.*

Another confusing, complex area relating to small issues involves the definition of principal users of "refunding" small issues. See F. Ballard, *Industrial Development Financing*, in *BASICS FOR MUNICIPAL BOND LAWYERS* 78 (1980) (R. Amdursky, ed.) [hereinafter cited as F. Ballard]; notes 33-34 *supra*. Neither the I.R.C. nor the Treasury Regulations define "principal user", but a Treasury Regulation implies that a principal user is a person who uses more than 10 percent of the IDB proceeds. See Treas. Reg. 1.103-8(a)(6) (1980); F. Ballard, *supra* at 78-81; R. PRICE, *supra* note 7, at 17. Since 90% is "substantial", then a user

The most serious abuse of the small issue results from broad construction of state IDB enabling statutes.⁷⁵ A community that needs to

of less than 10% cannot be a substantial user. See Treas. Reg. 1.103-8(a)(1) (1980); R. PRICE, *supra* note 7, at 5. Treasury Regulation § 1.103-8(a)(6) implies, therefore, that a user of more than 10% is a principal user. See F. Ballard, *supra* at 78-79. Further, the I.R.S. has stated that the Service generally will treat a non-exempt person as a principal user if the person occupies more than 10% of the space or receives more than 10% of the revenues earned from an IDB project. See Private Letter Ruling 8012065 (Dec. 27, 1979).

A final area of complexity and possible confusion is interpretation of the \$10 million small issue capital expenditure requirements. See I.R.C. § 103(b)(6)(B); *Impact Upon The Tax-Exempt Status*, *supra* note 36, at 729; note 35 *supra*. See generally Roberts, *supra* note 32, at 42-52; Wade, *Industrial Development Bonds—The Capital Expenditure Rule for \$10,000,000 Small Issues*, 34 BUS. LAW. 1771, 1771-1787 (1979). The user of bond proceeds must scrutinize carefully all of the capital expenditures during the entire six-year period, within which capital expenditures are includable in the aggregate face amount of a \$10 million IDB. See *Impact Upon The Tax-Exempt Status*, *supra* note 36, at 729; note 35 *supra*. Proper interpretation of the complex capital expenditure rules becomes critical when, for example, a purchaser of temporary mobile homes intends to sell the homes after completion of the project's construction. The I.R.S. may label the expenditures capital expenditures. See Rev. Rul. 75-208, 1975-1 C.B. 46. Although the purchaser uses the mobile homes only for office space during the construction of the IDB-financed building, the I.R.S. might include the price of the mobile homes in the \$10 million maximum aggregate face amount of the tax-exempt IDB. See *id.* Moreover, the proceeds from the subsequent sale of the mobile homes probably will not offset the aggregate face amount of the IDB for capital expenditure purposes. See *id.* at 47.

⁷⁴ See Roberts, *supra* note 32, at 6; note 68 *supra*.

⁷⁵ See SUBCOMM. REPORT, *supra* note 5, at 16. Financing private projects with IDB proceeds has met with unsuccessful state constitutional challenges. See generally Mitchell v. North Carolina Indus. Dev. Fin. Authority, 273 N.C. 137, 146, 159 S.E.2d 745, 755 (1968) (survey of constitutional challenges); note 81 *infra*. One common state constitutional challenge to IDB financing would hold that the proceeds of the IDBs were for private, not public purposes, contrary to the "public purpose" doctrine of the state's constitution. See, e.g., State v. Town of North Miami, 59 So.2d 779, 785 (Fla. 1952); Lowell v. City of Boston, 111 Mass. 454, 457 (1873); Beck v. City of York, 164 Neb. 223, 230, 82 N.W.2d 269, 274 (1957). The public purpose doctrine requires a publicly funded project to promote either public health or safety, general welfare, security or prosperity, or morals of those under control of the governing body. See, Tew, *Industrial Bond Financing and the Florida Public Purpose Doctrine*, 21 U. MIAMI L. REV. 171, 176 (1966) [hereinafter cited as Tew]. Normally, if the public benefit is sufficient, the bond project can incidentally benefit a private party. See State v. City of Miami, 379 So.2d 651, 653 (Fla. 1980); Tew, *supra* at 177. A Florida court has held that if a sufficient public purpose exists, the project's primary beneficiary can be a private party. See State v. Housing Fin. Auth. of Polk County, 376 So.2d 1158, 1160 (Fla. 1980); note 81 *supra*.

The other major state constitutional argument against IDB's has been the IDB's constitute an impermissible extension of public credit. See, e.g., Wayland v. Snapp, 334 S.W.2d 633, 637 (Ark. 1960); Mitchell v. North Carolina Development Financing Authority, 273 N.C. 137, 140, 159 S.E.2d 745, 749 (1968); Beck v. York, 164 Neb. 223, 230, 82 N.W.2d 269, 274 (1957). A typical credit clause generally prohibits lending the credit of a state, municipality or other governmental unit to aid an individual or private corporation. See Beck v. York, 164 Neb. 223, 226, 82 N.W.2d 269, 271 (1957); *Constitutional and Pragmatic Obstacles*, *supra* note 5, at 434.

Although proceeds for IDBs are raised under the auspices of the governmental authority, the bonds are backed only by the credit of the private user. See R. PRICE, *supra*

attract new business, to persuade existing firms to remain, or to demonstrate favorable attitudes toward business, generally finds IDBs an important component of the package of investment incentives.⁷⁶ Since all states have authorized some form of IDB,⁷⁷ the states are under a continuing pressure to construe more broadly the enabling statutes for competitive reasons.⁷⁸

Virginia has followed the trend of states broadly construing their own IDB enabling statutes.⁷⁹ In *City of Lexington v. Industrial Development Authority*,⁸⁰ the Virginia Supreme Court upheld the public purpose of a national retailer's commercial project under Virginia's IDB enabling statute and thus bestowed on local government authorities much broader discretion to authorize the issuance of IDBs than ever before in Virginia.⁸¹ In *City of Lexington*, the Industrial Development Authority of Rockbridge County (Authority) adopted a resolution for the issuance of a \$400,000 IDB for acquiring, constructing and equipping a retail sales facility.⁸² Since the aggregate authorized face amount of the bond was less than \$1 million, the bond feasibly could qualify as a small issue IDB under section 103(b)(6), and the interest received by bondholders would

note 7, at 1. Since the IDB is not backed by any "full faith and credit" of the governmental authority, however, IDBs arguably do not violate credit clauses. See note 21 *supra* and note 84 *infra*. Some jurisdictions have enacted separate constitutional provisions for IDBs. See note 5 *supra*.

⁷⁶ See SMALL ISSUE, *supra* note 5, at 46. But see text accompanying notes 53 & 56 *supra*.

⁷⁷ See note 13 *supra*.

⁷⁸ See, e.g., 114 CONG. REC. 26415 (1968) (statement of Sen. Proxmire); 114 CONG. REC. 26419 (1968) (statement of Sen. Brooke); SMALL ISSUE, *supra* note 5, at 46; note 43 *supra*.

⁷⁹ See text accompanying notes 77-78 *supra*.

⁸⁰ 221 Va. 876, 275 S.E.2d 888 (1981).

⁸¹ See *id.* at 881; text accompanying notes 93-96 *infra*. The Pennsylvania Supreme Court established the public purpose doctrine in *Sharpless v. Mayor of Philadelphia*, 21 Pa. 147, 185 (1853) (public purpose requirement implicit in Pennsylvania state constitution). See *Constitutional and Pragmatic Obstacles*, *supra* note 6, at 432. Since 1938, the federal courts, including the United States Supreme Court, have ruled only on ancillary issues concerning state and local issuance of bonds, rather than ruling on basic underlying principles. See *Industrial Location Incentives*, *supra* note 5, at 538. See generally *Carmichael v. Southern Coal Co.*, 301 U.S. 495, 514 (1937) (public purpose doctrine is requirement of fourteenth amendment); *Milheim v. Moffat Tunnel Improvement District*, 262 U.S. 710, 721 (1923) (determination of public purpose entitled to highest respect); *Green v. Frazier*, 253 U.S. 233, 242 (1920) (judgment of state's highest court declaring given use to be public in nature accepted by Court unless clearly unfounded); *Albritton v. City of Winona*, 181 Miss. 75, _____, 178 So. 799, 810, *appeal dismissed per curiam*, 303 U.S. 627 (1938) (United States Supreme Court closing door on federal review of principles underlying IDB financing); note 18 *infra*.

⁸² See 221 Va. at 876, 275 S.E.2d at 889; text accompanying note 57 *supra*. The Industrial Development Authority of Rockbridge County (Authority) adopted a bond resolution on December 5, 1979 which authorized both the issuance of \$400,000 for financing a retail sales facility and the leasing and sale of the facility to an individual or a corporation for the operation of a "K-Mart". See 221 Va. at 876, 275 S.E.2d at 889; Brief for Appellee, at 1, *City of Lexington v. Industrial Development Authority*, 221 Va. 876, 876, 275 S.E.2d 888, 889 (1981) [hereinafter cited as Brief for Appellee].

be tax-free.⁸³ The Authority issued the IDB pursuant to perceived authority under Virginia's Industrial Development and Revenue Bond Act⁸⁴ (Act). After the Authority resolved to issue the IDB, the Authority instituted a bond validation proceeding in the Rockbridge County, Virginia, Circuit Court under Virginia's Public Finance Act.⁸⁵ The Rockbridge County Circuit Court held the bonds valid.⁸⁶ The City of Lexington (Lexington) opposed the validation of the bonds and appealed to the Virginia Supreme Court to contest the circuit court validation decree.⁸⁷

On appeal, Lexington opposed the bond validation on the ground that the Act did not authorize the issuance of the bond.⁸⁸ Lexington also disputed the validation proceedings on jurisdictional grounds, contending that the Authority could not maintain a bond validation proceeding

⁸³ See I.R.C. § 103(b)(6); note 13 *supra*.

⁸⁴ See 221 Va. at 876, 275 S.E.2d at 889; VA. CODE § 15.1-1373 -91. The Virginia Industrial Development and Revenue Bond Act (Act) authorizes the governing body of any Virginia municipality to enact an ordinance to create a political subdivision of the Commonwealth. See VA. CODE § 15.1-1375(a). An Industrial Development Authority (IDB Authority) has both public and corporate powers as delegated by the Act. See *Indus. Dev. Auth. v. LaFrance Cleaners & Laundry Corp.*, 216 Va. 277, 282, 217 S.E.2d 879, 883 (1975); VA. CODE § 15.1-1376(a). The IDB Authority's powers are entirely vested in a seven-member board of directors, who are appointed by the governing body of the municipality. See VA. CODE § 15.1-1377. The Act vests an IDB Authority with the powers to borrow money from the Commonwealth or any subdivision, agency or public instrumentality of the Commonwealth and to issue bonds and acquire real and personal property, pledging the facilities and revenues therefrom. See VA. CODE § 15.1-1378. The Virginia Code deems that the bonds do not constitute the debt or pledge of the faith or credit of the Commonwealth, and therefore are not general obligation bonds. See VA. CODE § 15.1-1380; note 21 *supra*. The Act also gives an IDB Authority the powers to improve the properties, lease them and collect rent from them, and to convey with or without consideration the properties to the lessee when all indebtedness is paid off. See VA. CODE § 15.1-1378. The rents fixed by an IDB Authority as lessor must be at least sufficient to pay the principal and interest of the bonds and the cost of maintaining, repairing and operating projects as the debts become due. See *id.* § 15.1-1382. An IDB Authority must be non-profit, with no part of its net earnings, if any, inuring to the benefit of any individual, firm or corporation. See *id.* § 15.1-1384 (net earnings, if any, going to municipality).

⁸⁵ See *id.*; VA. CODE § 15.1-170 -227. The Virginia Public Finance Act establishes a procedure by which the "governing body" of a political subdivision that wishes to issue IDBs may validate the legality of the bonds and establish the validity of the pledges and other arrangements to pay off the bonds. See *id.* § 15.1-170 -227.

⁸⁶ See 221 Va. at 881, 275 S.E.2d at 889. The Rockbridge County Circuit Court determined that all of the Rockbridge County Industrial Development Authority's proceedings to validate the IDB were valid, and that the project to finance a "K-Mart" constituted an "authority facility" as defined in the Industrial Development and Revenue Bond Act. See *id.*

⁸⁷ See *id.*

⁸⁸ See Brief for Appellee, *supra* note 82, at 4. Lexington argued that the Virginia Code § 15.1-1374(d) definitions of "authority facility" and "facilities" limited an IDB Authority's power to finance a "commercial enterprise" under the Act. See Brief for Appellee, *supra* note 82, at 4. Included in the definition of authority facility are medical, pollution control and industrial facilities, and facilities for the aged, for education, for parking, and for other miscellaneous, specified purposes. See VA. CODE § 15.1-1374(d).

under Virginia's Public Finance Act.⁸⁹ Lexington argued that the validation provision of the Public Finance Act applies only to a Board of Supervisors, city council or other legislative authority in charge of governmental finances and not to an Industrial Development Authority⁹⁰ (IDB Authority). Lexington also argued that IDBs for private projects would give the private developer an unfair advantage over merchants unable to finance with IDBs.⁹¹ Lexington further contended that IDB financing would create unfair competition in the public bond market which would hurt financing possibilities for municipal bonds issued for necessary public improvements.⁹²

The Virginia Supreme Court in *City of Lexington* held that "industry" and "industrial" as used in the Act apply to commercial enterprises which sell and supply goods⁹³ as well as applying to manufacturing plants, factories and mills.⁹⁴ The court further ruled that a retail sales facility is a commercial enterprise under the Act,⁹⁵ and that the Act should promote development of retail sales facilities.⁹⁶ Additionally, the court found that an Industrial Development Authority is a political sub-

⁸⁹ See Brief for Appellee, *supra* note 82, at 4; text accompanying note 90 *infra*.

⁹⁰ See 221 Va. at 880, 175 S.E.2d at 891; Brief for Appellee, *supra* note 82, at 4. Lexington noted that the Virginia Public Finance Act defines "unit" as any county or municipality and defines "bonds" as obligations of a unit. See VA. CODE §§ 19.2-72(c) & (e); Brief for Appellee, *supra* note 82, at 4. Lexington argued that since § 19.2-72(f) defines revenue bonds as bonds of a unit, the validation proceeding is available only to counties and cities, not to IDB Authorities. See Brief for Appellee, *supra* note 82, at 4. Lexington also argued that if § 15.1-214 of the Public Finance Act applied to IDBs, the later enactment of the Industrial Development and Revenue Bond Act should have resulted in an amendment of Virginia's Public Finance Act to account for IDB financing. See Brief for Appellee, *supra* note 82, at 4. The Authority argued that the Authority's board of directors were a governing body under § 15.1-214 of the Public Finance Act. See Brief for Appellee, *supra* note 82, at 3-4.

⁹¹ See 221 Va. at 879, 275 S.E.2d at 890.

⁹² See *id.*; text accompanying note 21 *supra*.

⁹³ 221 Va. at 879, 275 S.E.2d at 891. Before holding that the Industrial Development and Revenue Bond Act applies to commercial as well as industrial projects, the *City of Lexington* court noted that the Virginia Supreme Court upheld that constitutionality of the first Virginia IDB enabling act in *Fairfax County Industrial Development Authority v. Coyner*, 207 Va. 351, 150 S.E.2d 87 (1966) (Chapter 643, Acts of Assembly, 1964, p. 975). See 221 Va. at 877, 275 S.E.2d at 891. The *Coyner* court held that the creation of an industrial development authority to promote industrial development by clothing such authorities with the power to finance and construct various facilities served a public purpose and was, therefore, a proper governmental function. *Id.* at 358, 150 S.E.2d at 94. *Coyner* also held that Fairfax County did not violate the credit clause in the Virginia constitution because neither the state nor the county would be liable to pay the bonds. *Id.* at 358, 150 S.E.2d at 94. A year after *Coyner*, *Industrial Development Authority of the City of Chesapeake v. Suthers*, 208 Va. 51, 155 S.E.2d 326 (1967), affirmed *Coyner* and upheld the constitutionality of the Industrial Development and Revenue Bond Act. *Id.* at 61, 155 S.E.2d at 330-333. The *Suthers* court stated that incidental benefit to private interests from the action of an IDB Authority does not destroy the action's public purpose. *Id.* at 59, 155 S.E.2d at 333.

⁹⁴ 221 Va. at 879, 275 S.E.2d at 891.

⁹⁵ *Id.* at 880, 275 S.E.2d at 890; see VA. CODE § 15.1-1374(j).

⁹⁶ 221 Va. at 880, 275 S.E.2d at 891; see VA. CODE § 15.1-1375; note 102 *infra*.

division of the Commonwealth⁹⁷ which properly brought the validation proceeding under Virginia's Public Finance Act.⁹⁸

In reaching the decision that IDB financing of a private commercial project constitutes a public purpose, the Virginia Supreme Court in *City of Lexington* relied on *Industrial Development Authority v. LaFrance Cleaners*.⁹⁹ In *LaFrance Cleaners*, the Virginia Supreme Court held that an IDB Authority's powers are legislative in nature.¹⁰⁰ The IDB Authority, however, may exercise legislative powers only when promoting a public purpose.¹⁰¹ Furthermore, the *LaFrance Cleaners* court stated that the elements listed in the Virginia legislature's statutory statement of the Act's purpose¹⁰² are each an indicium of the public purpose.¹⁰³ More importantly, the court found that a court may construe the terms of the Act disjunctively to effect the obvious legislative intent.¹⁰⁴ Therefore, the Virginia legislature has expressed by statute an intent to promote "commercial enterprises".¹⁰⁵

The court in *City of Lexington* reasoned that since a retail store assembles, stores and sells products of agriculture, mining and industry, the retailer's business met the Act's definition of "enterprise".¹⁰⁶ Relying

⁹⁷ 221 Va. at 881, 275 S.E.2d at 891.

⁹⁸ *Id.*; see note 90 *supra*.

⁹⁹ See 221 Va. at 881, 275 S.E.2d at 890; 216 Va. 277, 217 S.E.2d at 879 (1975).

¹⁰⁰ 216 Va. at 281, 217 S.E.2d at 883; see note 101 *infra*.

¹⁰¹ 216 Va. at 280, 217 S.E.2d at 882. In *LaFrance Cleaners* a laundry company challenged the validity of IDBs issued for another laundry facility. See *id.* at 278, 216 Va. at 880. The circuit court for the city of Richmond, Virginia, granted an injunction which invalidated the issuance of the bonds and interim financing, and enjoined the IDB Authority from borrowing additional funds to finance the laundry. *Id.* at 279, 216 Va. at 881. The circuit court reasoned that the legislative intent reflected in VA. CODE § 15.1-1375 expressly required the IDB Authority's powers to be exercised for the benefit of the Commonwealth to increase commerce and promote safety, health and welfare. See 216 Va. at 279, 217 S.E.2d at 881. The lower court interpreted § 15.1-1375 to require that terms of the section be treated conjunctively, not disjunctively. See 216 Va. at 279, 217 S.E.2d at 881. To evaluate public purpose, therefore, courts can only look conjunctively at the elements of public purpose which the legislature has described. See *id.* at 279, 217 S.E.2d at 881.

¹⁰² See VA. CODE § 15.1-1375. Section 15.1-1375 of the Virginia Code states that the legislative intent for the Industrial Development and Revenue Bond Act is to promote industry and develop trade by encouraging, among other things, manufacturing, industrial and commercial enterprises to locate and remain in Virginia. See *id.*; text accompanying notes 105-106 *infra*.

¹⁰³ 216 Va. at 280, 217 S.E.2d at 882; see 221 Va. at 878, 275 S.E.2d at 890.

¹⁰⁴ 216 Va. at 280, 217 S.E.2d at 882; see Va. at 878, 275 S.E.2d at 890. In addition to disjunctively construing the terms of the Industrial Development and Revenue Bond Act (Act), the court must rationally construe the Act so as not to defeat its purposes. See *Norfolk So. Ry. Co. v. Lassiter*, 193 Va. 360, 364, 68 S.E.2d 641, 643-4 (1952).

¹⁰⁵ See VA. CODE § 15.1-1375; 221 Va. at 880, 275 S.E.2d at 889; text accompanying note 102 *supra*.

¹⁰⁶ See 221 Va. at 879, 275 S.E.2d at 890. The Industrial Development and Revenue Bond Act broadly defines "enterprise" as any industry which, among other things, assembles, stores or sells products of agriculture, mining or industry. See VA. CODE § 15.1374(j).

on another jurisdiction's definition of industry as any business conducted for profit¹⁰⁷ and considering the Virginia Supreme Court's earlier mandate to construe the Act liberally,¹⁰⁸ the *City of Lexington* court held that "industry" and "industrial" under the Act include commercial enterprises.¹⁰⁹ The Virginia Supreme Court construed the definition of retail sales facility to fit the Act's definition of enterprise and then defined "commercial" as a subset of industrial. Finally, the court reasoned that the Virginia legislature's statement of the purpose of the act indicated an intent to authorize IDB financing to induce retail sales facilities to locate in Virginia.¹¹⁰

Many jurisdictions have not construed their IDB enabling statutes as broadly as has Virginia, and a few jurisdictions still oppose IDB financing.¹¹¹ The Idaho Supreme Court held Idaho's IDB enabling statute unconstitutional¹¹² because the tax exemption arbitrarily and unjustly preferred one private enterprise over another.¹¹³ The Idaho court stated that if the state-favored industries were successfully managed, the state through municipalities would increasingly control private business as non-state-favored industries were forced out of business.¹¹⁴ The Idaho court further noted that the tax exemption would cast additional tax burdens on citizens and non-state-favored industries.¹¹⁵ North Carolina courts also do not regard IDB financing favorably, holding that an authority whose primary function is to equip facilities for private enterprise does not serve a public purpose.¹¹⁶ The Supreme Court of North Carolina held the state's IDB enabling act unconstitutional¹¹⁷ because the power of taxation may never be contracted away,¹¹⁸ and because it was

¹⁰⁷ See 221 Va. at 879, 275 S.E.2d at 890, quoting *Weatherford v. Arter*, 135 W. Va. 391, 395, 63 S.E.2d 572, 574 (1951).

¹⁰⁸ See 221 Va. at 880, 275 S.E.2d at 890; note 104 *supra*.

¹⁰⁹ See 221 Va. at 880, 275 S.E.2d at 890.

¹¹⁰ See 221 Va. at 880, 275 S.E.2d at 889-891; text accompanying notes 105-09 *supra*.

¹¹¹ See *Industrial Location Incentives*, *supra* note 5, at 541; text accompanying note 13 *supra* & notes 112-19 *infra*.

¹¹² See *Village of Moyie Springs, Idaho v. Aurora Company*, 82 Idaho 337, ___, 353 P.2d 767, 775 (1960). Idaho's Code today provides for the issuance of IDBs by local units of government only for deep water ports. See IDAHO CODE § 77-1901 to -1913.

¹¹³ See 82 Idaho at ___, 353 P.2d at 775 (private enterprise not favored by IDBs could not otherwise compete for industries using IDBs).

¹¹⁴ See *id.* (socialism would replace free enterprise with influence of IDBs).

¹¹⁵ See *id.*; note 21 *supra*.

¹¹⁶ See *Stanley v. Department of Conservation & Dev.*, 284 N.C. 15, 33, 199 S.E.2d 641, 658 (1973); *Mitchell v. North Carolina Financing Auth.*, 273 N.C. 137, 159, 159 S.E.2d 745, 761 (1968).

¹¹⁷ See *Mitchell v. North Carolina Fin. Dev. Auth.*, 273 N.C. at 159, 159 S.E.2d at 761 (1968).

¹¹⁸ See *id.* at 143, 159 S.E.2d at 749-750; N.C. CONST. art. V, § 3 (1963); N.C. CONST. art. V, §§ 2(1) and 2(3) (current provision).

not the North Carolina government's function to engage in private business.¹¹⁹

The reasoning of the Idaho and North Carolina courts is sound and should be adopted by other states. Other states, however, have not adopted similar reasoning, because there are competitive reasons for states construing their respective enabling statutes more broadly.¹²⁰ Therefore, Congress must revise section 103(b) to prevent further abuse.¹²¹ Congress should deny the IDB tax exemption unless the issuer targets the IDB to aid either small businesses, economically distressed areas or industrial firms but not large, private commercial enterprises.¹²² To define a "small business", Congress could rely on the Small Business Administration criteria for defining small businesses¹²³ or could limit assistance according to a firm's capital assets.¹²⁴ To determine whether an area is economically distressed, criteria used in the Urban Development Action Grant's¹²⁵ "pockets of poverty" program might be helpful.¹²⁶ Alternatively, Congress could restrict IDBs solely to areas of high unemployment.¹²⁷

Several other possible solutions exist to help solve small issue IDB problems. Federal regulations could limit per state or per capita volume of IDB sales.¹²⁸ Individual states would then establish eligibility criteria to meet the state's limit.¹²⁹ With a fifty dollar per capita limit on the volume of small issue sales per state, for example, the states might authorize IDB financing more selectively.¹³⁰ Alternatively, Congress

¹¹⁹ See 273 N.C. at 145, 159 S.E.2d at 758; *Stanley v. Department of Conservation & Dev.*, 284 N.C. 15, 35-41, 199 S.E.2d at 654-658 (1973) (affirming *Mitchell*). The North Carolina legislature in 1975 approved a constitutional amendment to permit IDB financing for industrial purposes only. See SMALL ISSUE, *supra* note 5, at 20; *Subcomm. Hearings*, *supra* note 14, at 117 (Review of Borrowing Practices, Oregon Governor's Bonded Debt Advisory Panel). Additionally, only industrial projects in North Carolina which create at least 100 jobs for each \$7.5 million invested qualify for IDB financing. See SMALL ISSUE, *supra* note 5, at 20.

¹²⁰ See text accompanying notes 77-78 *supra*.

¹²¹ See text accompanying notes 122-138 *infra*.

¹²² See H.R. 4420, 97th Cong., 1st Sess. (1981); SUBCOMM. REPORT, *supra* note 6, at 21-22; *Industrial Location Incentives*, *supra* note 5, at 547-550; SMALL ISSUE, *supra* note 5, at 59-63. The elimination of IDBs for commercial projects would ease the rapid growth of small issues, and many larger corporations would find alternative financing. See SMALL ISSUE, *supra* note 5, at 62-63; note 109 *supra*.

¹²³ See SMALL ISSUE *supra* note 5, at 60.

¹²⁴ See *id.*

¹²⁵ See *id.* at 61 (UDAG); SUBCOMM. REPORT, *supra* note 6, at 22.

¹²⁶ See SMALL ISSUE, *supra* note 5, at 61.

¹²⁷ See *id.*

¹²⁸ See *id.* at 63-64. Several states have set \$50 per capita limits, based on population, on IDB sales volume. See *id.* at 64. Pennsylvania has the largest per capita average, \$319. See *id.* at 64 & 98. Alternatively, states could limit IDB's to areas with populations less than 50,000, or to areas with a labor surplus. See *Industrial Location Incentives*, *supra* note 5, at 549.

¹²⁹ See *id.* at 63-64.

¹³⁰ See *id.* at 64.

could limit the tax exemption to general obligation bonds.¹³¹ Although states or localities could still issue IDBs, the state or local government would back the bonds by the full faith and credit of the state or local government.¹³² Although this alternative would eliminate IDBs in most states which have constitutional credit clauses prohibiting the state or its political subdivisions from making loans or gifts to private parties, the remaining states could permit governmental units to issue IDBs.¹³³ The state or locality would stand behind the IDBs in case of default, and the federal government could not interfere with local public purpose determinations.¹³⁴

A final alternative is to eliminate the small issue tax exemption entirely.¹³⁵ Because of the arguably remote public purpose of many small issues and of the difficulty in drafting legislation which targets assistance to businesses, industries, or regions that need assistance most, Congress should consider elimination of the small issue.¹³⁶ Of course, elimination of the small issue could result in the loss of many projects, absent alternate financing methods.¹³⁷ By contrast, the Treasury would recoup lost tax revenues.¹³⁸

In recent years, the volume of small issue IDBs has grown faster than ever.¹³⁹ Large national corporations are taking advantage of the I.R.C. section 103(b)(6) tax exemption for small issues by financing major expansion programs when other sources of financing are available.¹⁴⁰ The 1968 congressional intent for creating the small issue was to aid the small corporation in economically distressed areas.¹⁴¹ Not only does the Treasury suffer large losses of income tax revenues,¹⁴² but municipalities pay higher interest rates on true municipal bonds because of market pressures the large volume of IDBs causes.¹⁴³ Since every state offers some form of IDB¹⁴⁴ and virtually all states allow small issue IDBs,¹⁴⁵ the

¹³¹ See *id.* at 64-65. By limiting the tax exemption to general obligation bonds, Congress could avoid defining public purpose and IDB qualifying criteria. See *id.* at 64; notes 6 & 21 *supra*.

¹³² See *Industrial Location Incentives*, *supra* note 5, at 64. An alternative to IDB financing would be to eliminate small issues except when the state or local governmental unit pledges funds which match the amount of the IDB. See *id.* at 64. Under this plan, states would be more selective in determining whether to finance a project. See *id.*; notes 6, 21 & 77-78 *supra*.

¹³³ See SMALL ISSUE *supra* note 5, at 65.

¹³⁴ See *id.* at 65; note 6 *supra*.

¹³⁵ See SMALL ISSUE *supra* note 5, at 65.

¹³⁶ See *id.*

¹³⁷ See *id.*

¹³⁸ See note 52 *supra*.

¹³⁹ See text accompanying notes 48-51 *supra*.

¹⁴⁰ See text accompanying notes 14 & 57-61 *supra*.

¹⁴¹ See text accompanying notes 17 & 36-40 *supra*.

¹⁴² See text accompanying notes 20 & 52 *supra*.

¹⁴³ See text accompanying notes 21 & 50 *supra*.

¹⁴⁴ See text accompanying note 5 *supra*.

¹⁴⁵ See text accompanying note 13 *supra*.

result is that courts construe more broadly state IDB enabling statutes, thus permitting IDB financing of commercial as well as industrial projects.¹⁴⁶ The state trend is to construe their own enabling statutes more liberally to maintain a competitive business climate.¹⁴⁷ To arrest this trend, and thus to remedy the growing abuse of small issues, Congress is the proper authority for action.¹⁴⁸ The best method of preventing abuse of IDBs is to eliminate IDBs for private commercial purposes unless targeted for small corporations or economically distressed areas.¹⁴⁹

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¹⁴⁶ See text accompanying notes 16 & 79-110 *supra*.

¹⁴⁷ See text accompanying notes 75-78 *supra*.

¹⁴⁸ See text accompanying note 121 *supra*.

¹⁴⁹ See text accompanying notes 122-139 *supra*.