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IRS Releases Guidance Impacting the Ability to Use Draw-Down Bonds for Small Issue (Manufacturing) Bonds and Implications for Midwestern Disaster Area Bonds and Other Exempt Facility Bonds

Background

On November 23, 2010, the Internal Revenue Service (IRS) released Notice 2010-81 (the “Original Notice”), which provided guidance relating to the ability of issuers to issue draw-down bonds in the context of certain provisions of the American Recovery and Reinvestment Act that were scheduled to “sunset” on December 31, 2010. Surprising to many bond practitioners was that the Original Notice provided without explanation that it also applied to “various volume cap limitations on state and local bonds.”

On August 3, 2011, the IRS released Notice 2011-63 (the “Supplemental Notice”), which provides supplemental guidance on the determination of when state and local bonds, particularly draw-down loans and commercial paper, are considered “issued” for purposes of volume cap limitations on private activity bonds under § 146 and other volume caps and limitations under federal law.

Customary Practice Relating to Draw-Down Bonds

Customary practice among bond counsel firms and interpretation of the Treasury Regulations relating to draw-down bond structures was that in accordance with Section 1.150-1(c)(4)(i), the bonds were deemed to be issued (for all purposes, including the volume cap provisions) when the lesser of 5% of the principal amount of the bonds or \$50,000 in bond proceeds were drawn. The result was

that an issuer could obtain “volume cap” to issue, for example, \$5,000,000 in bonds. When at least \$50,000 was drawn, \$5,000,000 of bonds was deemed to have been issued.

The Original Notice and Supplemental Notice (the “Notices”) require a different treatment to that long-standing practice for bonds issued in a draw-down structure—a practice which has been scrutinized on random audit and sustained in the past. The impact is particularly harsh for Small Issue (Manufacturing) Bonds.

Impact on Midwestern Disaster Area Bonds

The Notices do not specifically address Midwestern Disaster Area Bonds (MDABs); however by implication from references to Gulf Opportunity Zone Bonds, we interpret the Notices to allow the continued ability to issue MDABs in a draw-down structure so long as all bond proceeds are drawn (or disbursed into a project fund) on or before December 31, 2012 (the sunset date of the MDAB program).

Impact on Small Issue (Manufacturing) Bonds

Bonds issued as Small Issue (Manufacturing) Bonds require state volume cap. The volume cap for these bonds do not allow them to be carried forward to subsequent years for bonds issued in subsequent years.

With some exceptions (see MDAB

discussion above), bonds are now deemed to be issued when the bond proceeds are disbursed. Therefore, if the bonds were structured as a draw-down bond and \$50,000 were drawn in year one, \$1,500,000 in year two and \$3,000,000 in year three, under the Notices, bonds would have been issued in each of those years in the respective amounts and would require allocation of volume cap in those amounts in each of those years.

The difficulty for small manufacturers is that they cannot always predict the precise amount they will draw in a given calendar year. That, along with the additional burden to apply for and receive volume cap (of which there can be no guaranty) and the additional record keeping and reporting obligations, may make issuance of Small Issue (Manufacturing) Bonds in a draw-down structure no longer a workable option in most cases.

We will be discussing the volume cap implications with the representatives of the Wisconsin Economic Development Corporation (f/k/a Wisconsin Department of Commerce), which is the agency that allocates volume cap and other industry resources, in an effort to develop a workable option to preserve the advantages of this financing structure.

Impact on Exempt Facility Bonds

Exempt Facility Bonds, such as multifamily housing bonds and solid waste disposal facility bonds, which could apply for and receive a carry forward of the state's volume cap, can still be issued as draw-down bonds.

Effective Date

The Notices apply to bonds issued after August 3, 2011.

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