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IRS Limits Use of Draw-Down Bonds for BABs: Makes Exception for Bank Qualified Bonds

The IRS has — at last — provided guidance that generally *prohibits* the use of "draw-down bonds or loans" and similar structures where the bond proceeds will not be fully funded at closing to avoid the December 31, 2010 deadline for Build America Bond issuances, but importantly *permits* the use of draw-down structures for "bank qualified bonds" under Section 265(b)(3) of the Code. In recent months, the municipal bond market has been grappling with the implications of the pending deadlines for the American Recovery and Reinvestment Act of 2009 ("ARRA"). In particular, the authorization for Build America Bonds ("BABs") and other types of bonds authorized by ARRA is set to expire on December 31, 2010. Certain existing IRS regulations suggested that issuers could maximize the benefits of BABs by issuing the bonds as "draw-down loans" prior to December 31, with only a portion of the proceeds immediately advanced and later portions advanced following December 31, since the date of the "issue" would be the date of the first draw-down. Similar rules apply for commercial paper, and it was thought that this analysis would permit the use of BABs to finance projects even when the full amount of the debt was not funded until after December 31.

Unfortunately, in [Notice 2010-81](#) promulgated on November 23, 2010, the IRS has stated that, for purposes of the ARRA deadlines, it is the "issue date of the *bond*" that matters, and not the issue date of the *issue*. In other words, if the proceeds of any bond that is a part of a larger issue of BABs are not advanced until after December 31, such bonds will no longer be treated as BABs (assuming the December 31 statutory deadline is not extended). As a result, if a BABs issue, or another type of bond benefitting from an ARRA provision with a deadline, has been the subject of a draw-down structure or commercial paper structure, *only those portions of the debt actually drawn or issued before the expiration date get the benefit of the statutory treatment*. This effectively eliminates any benefit of using the draw-down structure for those types of bonds beyond 2010. To the extent any such bonds have been issued as draw-down bonds, those proceeds must be fully funded by the end of 2010 in order for the entire issue to receive the expected tax treatment under ARRA.

Notice 2010-81 applies to:

> " . . deadlines for issuing State and local bonds such as Build America Bonds under §§ 54AA(d), 54AA(g) and 6431, and Recovery Zone Bonds under §§ 1400U-1 through 1400U-3. The analysis in this Notice also applies for other

deadlines for issuing bonds, such as, among others, the exceptions to the alternative minimum tax preferences and adjustments for interest on certain tax-exempt bonds under §§ 56(g)(4)(B)(iv) and 57(a)(5)(C)(vi), Gulf Opportunity Zone Bonds under § 1400N and various volume cap limitations on State and local bonds (as defined in § 103(c)).

This Notice does not apply for purposes of applying the qualified small issuer and de minimis exceptions to the tax-exempt carrying cost disallowance provision under § 265(b)(3) and § 265(b)(7) to draw-down loans. For this purpose, Rev. Rul. 89-70 will continue in effect until further guidance is provided, which guidance will be prospective.

The second paragraph of the quoted provision provides an important exception. Draw-down and commercial paper structures will work for purposes of the bank-qualified bond tests of Section 265 — both the ARRA provisions allowing up to $30 million in such bonds for each qualified entity in 2010 and the application of that test at the borrower level for 501(c)(3) bonds, and the special application of the 2% de minimis test for bonds issued in 2010. This difference in treatment is not necessarily always beneficial to issuers and borrowers since it will require the full amount of the "issue" to count against the 2010 limit even if most of the proceeds are not drawn or delivered during that calendar year, but would permit issues that are taking advantage of the unique features of ARRA to be issued as draw-down bonds.