

Frequently Asked Questions

This document provides general information about financing with tax-exempt small issue manufacturing bonds under Section 144(a)(12) of the Internal Revenue Code (the Code). Each financing is unique, and the applicable federal and state laws are complex and varied. Accordingly, the answers below are not intended to provide an exhaustive discussion of the topic and do not constitute legal advice.

Q What are tax-exempt small issue manufacturing bonds?

Tax-exempt small issue manufacturing bonds, often called industrial development bonds or IDBs, are obligations issued by a governmental entity to stimulate private economic development. The governmental entity (the Issuer) sells the IDBs and loans the sale proceeds to a private corporation (the Borrower) to acquire or construct manufacturing facilities (as described in more detail below). The Borrower's loan payments are structured to cover the payment of principal and interest to the bondholders, for whom the interest payments are exempt from federal income tax. Because IDBs are paid solely from the revenues that the financed facilities generate and any other security that the Borrower provides, IDBs are not direct obligations of the Issuer.

Q How does IDB financing compare to other options?

Because the interest that bondholders earn on IDBs is tax exempt, the interest rate a Borrower pays on an IDB financing is generally lower than the rate the Borrower would pay on a conventional loan. The resulting debt service savings over the life of the loan is often significant.

The procedural requirements associated with IDB financing are generally more intensive than those associated with conventional loans. Accordingly, costs of issuance, which include legal fees paid to bond counsel for preparing documents and rendering a legal opinion on the tax-exempt status of the IDBs, are generally higher. Further, Borrowers who obtain IDB financing must comply

with certain tax covenants and restrictions on the use of the financed facilities. These covenants and restrictions are incorporated into the legal documents prepared by bond counsel.

Another difference between IDB and conventional loan financing concerns the depreciation of the financed assets. Property financed with IDBs must be depreciated for tax purposes using the straight-line method rather than an accelerated method. The impact of this requirement may be negligible if the financed property has a 40-year applicable recovery period. For certain kinds of equipment, however, the prohibition against accelerated depreciation may be more significant.

Q What can a Borrower finance with IDB proceeds?

The Borrower can use IDB proceeds only to finance manufacturing facilities and facilities "directly related and ancillary to a manufacturing facility." According to the Code, a manufacturing facility is one "used in the manufacture or production of tangible personal property (including the processing resulting in a change in the condition of such property)." In addition, for IDBs issued in 2009 and 2010 only, a manufacturing facility is one used in the manufacturing, creation, or production of intangible property, including any patent, copyright, formula, process, design, know how, format, or other similar item. Ancillary facilities qualify for IDB financing under the Code if they are located on the same site as the manufacturing facility and are "subordinate" and "integral" to the manufacturing process occurring at the facility. Typical ancillary facilities include warehouses to temporarily store raw materials

or finished products. For IDBs issued in 2009 and 2010, the Code imposes no limit on the percent of net IDB proceeds that can be spent on ancillary facilities. Aside from the foregoing requirements, the Code contains certain limitations applicable to all tax-exempt private activity bonds. For example:

- Proceeds used to acquire land (directly or indirectly) must comprise less than 25% of the total proceeds.
- Subject to certain exceptions unlikely to apply in an IDB financing, no proceeds may be used to acquire land for farming purposes.
- Subject to an exception for circumstances in which existing facilities will undergo substantial rehabilitation, no proceeds may be used to acquire existing structures (or used equipment).
- Proceeds may not be used to finance certain kinds of facilities (including health clubs, commercial golf courses, and race tracks, among others), but none of these uses is likely to be involved in an IDB financing.
- Proceeds used to finance costs of issuance must comprise no more than 2% of the total proceeds.

Q What is the maximum term of an IDB financing?

The weighted average maturity of the IDBs cannot exceed 120% of the average reasonably expected economic life of the facilities they finance. Individual states may impose maturity limitations that are more restrictive than the federal limitation.

Q What is the maximum principal amount that may be financed through IDBs?

The Code contains several provisions affecting the principal amount of IDBs an Issuer is authorized to sell on behalf of a Borrower. First, the Issuer may issue:

- up to \$1,000,000 in principal amount, less the principal amount of certain outstanding tax-exempt bonds, if any, issued by any authorized issuer to finance facilities that (a) are located in the same incorporated municipality (or county, if the existing facilities are not located in an incorporated municipality) and (b) are used by the same Principal User¹ or Related Person²; or

- up to \$10,000,000 in principal amount, if the sum of the following is \$20,000,000 or less:
 - (a) the principal amount of the IDBs; plus
 - (b) certain outstanding tax-exempt bonds, if any, issued by any authorized issuer to finance facilities that (i) are located in the same incorporated municipality (or county, if the existing facilities are not located in an incorporated municipality) and (ii) are used by the same Principal User or Related Person; plus
 - (c) all non-bond financed capital expenditures³ paid by or for the same Principal User or Related Person during the six-year period surrounding the closing date for the IDBs (i.e., three years before the date and three years after) for facilities located in the same incorporated municipality (or county, if the existing facilities are not located in an incorporated municipality).

Notwithstanding the foregoing provisions, the principal amount of tax-exempt bonds issued may not exceed \$40,000,000 when added to the aggregate principal amount of all other small issue bonds and qualified redevelopment bonds outstanding at the time of the issue in question and attributable to the same Test Period Beneficiary⁴ (and Related Persons).

Q What are the procedural steps involved in an IDB financing?

The first step is to identify which governmental entities are authorized under state law to issue IDBs and to initiate communication with the most appropriate Issuer, which the Borrower will generally determine based on the project's location. Once the Issuer has agreed to work with the Borrower, it must take preliminary official action (e.g., adopt a resolution) on the proposed issuance.

The Borrower must then apply to the appropriate governmental entity, which is often different from the Issuer, for an allocation of the applicable "volume cap." The volume cap is the maximum amount of tax-exempt bonds that may be issued to finance a particular qualified purpose during a calendar year. State law designates the entity to which the Borrower must submit the volume cap application. In many instances, the Borrower must pay an application fee equivalent to a certain percent of the principal amount of IDBs to be issued.

The Issuer must then hold a public hearing on the issuance of the IDBs, having provided published notice in advance of the hearing in accordance with applicable state and federal law. Only after the hearing has occurred may the Issuer take final official action (usually by adopting a resolution) authorizing the issuance of the IDBs. The financing may then proceed to closing.

Depending on the structure of the financing, the Borrower will either make its loan payments to the Issuer directly or on behalf of the Issuer to a trustee or bondholder(s). The Borrower must comply with the applicable tax covenants and restrictions on the use of the financed facilities as long as any of the bonds are outstanding. A violation of such covenants and restrictions may cause the IDBs to lose their tax-exempt status, at which point the Borrower may be liable for increased costs calculated retroactively to the date of issuance.

For more information about financing manufacturing facilities with tax-exempt bonds, please contact any of the following Dorsey attorneys:

DENVER

Douglas W. Fix
303-629-3449
fix.doug@dorsey.com

Jane Roberts
303-628-1501
roberts.jane@dorsey.com

DES MOINES

Amy Bjork
515-699-3285
bjork.amy@dorsey.com

David L. Claypool
515-699-3275
claypool.david@dorsey.com

John Danos
515-699-3275
danos.john@dorsey.com

Darla M. Giese
515-699-3293
giese.darla@dorsey.com

David G. Grossklaus
515-699-3287
grossklaus.david@dorsey.com

Robert E. Josten
515-283-1000
josten.robert@dorsey.com

Cristina Kuhn
515-699-3273
kuhn.cristina@dorsey.com

James Smith
515-699-3276
smith.james@dorsey.com

MINNEAPOLIS

Lynnette Slater Crandall
612-343-8288
crandall.lynnette@dorsey.com

Lynn Endorf
612-340-2651
endorf.lynn@dorsey.com

Jerome P. Gilligan
612-340-2962
gilligan.jerome@dorsey.com

Jennifer L. Hanson
612-492-6959
hanson.jennifer@dorsey.com

Andrea B. Hedtke
612-492-6912
hedtke.andrea@dorsey.com

Richard A. Helde
612-343-7912
helde.richard@dorsey.com

Jay R. Lindgren
612-492-6875
lindgren.jay@dorsey.com

Michael E. Reeslund
612-340-2960
reeslund.mike@dorsey.com

Leonard S. Rice
612-343-7971
rice.len@dorsey.com

Paula S. Rindels
612-343-7983
rindels.paula@dorsey.com

Andrea Specht
612-492-6917
specht.andrea@dorsey.com

Suzanne B. Van Dyk
612-340-5631
van.dyk.suzanne@dorsey.com

Thomas D. Vander Molen
612-340-2934
vander.molen.tom@dorsey.com

MISSOULA

Jeremy Brown
406-721-6025
brown.jeremy@dorsey.com

Mae Nan Ellingson
406-721-6025
ellingson.mae.nan@dorsey.com

Dan Semmens
406-721-6025
semmens.dan@dorsey.com

NEW YORK

David Fernandez
212-415-9362
fernandez.david@dorsey.com

Melissa Paparone
212-415-9304
paparone.melissa@dorsey.com

- 1 Generally, any person or entity that owns or leases 10% or more of, or purchases more than 10% of the output of, a facility is a Principal User of that facility. A person or entity that leases 10% or more of the facility for less than one-year is generally not considered a Principal User.
- 2 For this purpose, Related Persons are generally (a) members of a group of corporations that share more than 50% ownership or control; or (b) persons or entities deemed to be related for the purposes of Section 267 or 707(b) of the Code, including family members.
- 3 Capital expenditures can include expenditures made by a local government to assist with a facility. Capital expenditures do not include: (a) public utility improvements for a facility; (b) leased personal property, as long as it is leased by a person in the trade or business of leasing property or by the manufacturer of the property; (c) expenditures required by a change in law or because of casualty; or (d) expenditures of up to \$1,000,000 that could not be reasonably foreseen when the tax-exempt bonds are issued.
- 4 A Test Period Beneficiary is generally an owner or Principal User of the financed facility at any time during the three-year period that begins on the later of the date the facility is placed in service and the date of issue. Depending on the type of user, tax-exempt bonds that are attributed to Test Period Beneficiaries are allocated based on percentage ownership of a facility, percentage of use based on fair rental value, or percentage of output purchased.