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Public Finance

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Tax-Exempt Financing of Working Capital Expenditures

Shortfalls and delays in revenue collection brought about by the consequences of the ongoing COVID-19 coronavirus outbreak are prompting issuers and conduit borrowers to seek financing opportunities to cover necessary operating expenses. As you work to find solutions and structure practical approaches to these economic challenges, we want to remind you of the basic parameters of how tax-exempt bond proceeds may be used as part of the solution. This publication outlines the general rules for using tax-exempt bond proceeds to pay COVID-19 and other working capital expenditures. It is not intended to represent a complete discussion of how the rules and related calculations are applied. Kutak Rock's national Public Finance Group and national Public Finance Tax Group are ready to assist in any financing of working capital expenditures and can help develop a structure that meets the needs of issuers and conduit borrowers.

This publication does not address the federal government's Municipal Liquidity Facility announced April 9, 2020 and expanded April 27, 2020 to help state and local governments better manage cash flow pressures resulting from the COVID-19 coronavirus outbreak. Pursuant to the Municipal Liquidity Facility, the federal government intends to purchase up to $500 billion of short-term notes issued by states, counties with a population of at least 500,000 residents and cities with a population of at least 250,000 residents. To determine whether the Municipal Liquidity Facility will be available to fund the working capital needs of issuers or conduit borrowers, please contact John Petr for referral to the appropriate member within the Public Finance Group.

Introduction

Proceeds of tax-exempt bonds may be used to pay "working capital expenditures" only in limited circumstances, as described below. What are working capital expenditures? The regulations define these expenditures simply as costs that are not capital expenditures. A "capital expenditure" is an expenditure that is or can be capitalized under general federal income tax principles. The treatment of an expenditure under applicable accounting rules is often, but not always, the same as the treatment of an expenditure under federal income tax rules. The determination of whether an expenditure is a working capital expenditure or a capital expenditure will sometimes need to be made on a case-by-case basis, because the context of the expenditure will be relevant to the determination.

Examples of working capital expenditures include employee salaries and benefits (unless clearly documented and allocable to a capital project), operating lease payments, debt service payments and other current operating expenditures. Examples of capital expenditures include costs incurred to acquire, construct or improve land, buildings and equipment and interest paid on an obligation before the related project is placed in service (capitalized interest).

There are four general circumstances in which working capital may be needed: (1) to address a temporary cash flow or operating deficit, such as deficits arising due to the COVID-19 coronavirus outbreak; (2) to address long term structural deficits; (3) as a component of a larger project relating to newly financed or refinanced capital expenditures; and (4) to fund extraordinary, nonrecurring costs not customarily payable from current revenues. These four circumstances are described in more detail below. The federal tax rules that guide the analysis relating to tax-exempt financing generally look to *when* bond proceeds are treated as spent on working capital expenditures and *how long* the bonds are proposed to be outstanding.

State Law Limitations

The ability to issue any kind of bonds to finance working capital needs depends heavily on state law, which may differ significantly from one state to the other. Be sure to carefully evaluate state law with a member of the Public Finance Group.

Bond Proceeds Used for Short-Term Operating Needs

An issuer or borrower may require cash to bridge a temporary cash flow or operating deficit. Such a deficit may arise in the regular course of operations from a difference in time between when expenses must be paid and when revenues are received. For example, a city may be required to make general fund expenditures towards the beginning of the fiscal year but might not receive tax revenues until later in the fiscal year. A fiscal gap may also arise from an unexpected event, such as the ongoing COVID-19 coronavirus pandemic or other economic disruptions, which temporarily postpones revenue collections or generation. A properly structured financing can help the issuer effectively manage these fiscal needs. If the working capital rules are followed carefully, the financing may qualify for issuance on a tax-exempt basis.

Bonds issued for these needs are typically issued as tax or revenue anticipation notes, often abbreviated as TRANs, TANs or RANs. The tax code does not specifically define when a bond is a tax or revenue anticipation note. Such a note is commonly understood to refer to a short-term instrument, with a typical term of less than 13 months. The note is usually paid off in full by the maturity date, sometimes with interim redemption payments based on a schedule of when revenues are anticipated to be received. Some jurisdictions require short-term working capital financings to be repaid using revenues from the same fiscal year.

A fundamental tax exemption requirement for these types of bonds is to prove that all of the proceeds of the bonds will be properly spent within statutory and regulatory timeframes. Proceeds can be treated as spent on working capital only to the extent the issuer experiences actual revenue deficits. The aggregate revenue deficits will determine the size of the tax-exempt financing. One typical approach for sizing the transaction is to evaluate what the issuer's expected aggregate deficit will be within six months after the issue date (referred to as "cumulative cash flow deficit"). "Cumulative cash flow deficit" means the excess of actual expenses paid during the period that would ordinarily be paid out of or financed by anticipated tax or other revenues, over the aggregate amount available to the issuer during such period for the payment of such expenses. The tax-exempt bond size under this approach should not exceed an amount equal to the cumulative cash flow deficit divided by 90%. The process and rules for determining the correct size of a TRAN, TAN or RAN are highly technical. Please reach out to members of the Public Finance Tax Group for assistance in evaluating whether this type of short-term financing can be done on a tax-exempt basis.

Bond Proceeds Used for Long-Term Operating Needs

It is also possible to issue tax-exempt bonds to finance long-term working capital needs. Often, these needs are caused by structural deficits an issuer is experiencing other than the mere temporary mismatch of the timing of receipts and disbursements within a year that are contemplated by TRAN, TAN and RAN financings. Two basic tax issues to address for a long-term working capital financing are (1) to make sure proceeds will be properly treated as "spent" and (2) to make sure the term of the financing is not too long. If the proceeds cannot be properly spent or the term is too long, the bond may be considered a taxable arbitrage bond.

As with short-term working capital bonds, proceeds of a long-term working capital bond will be treated as spent to the extent expenditures of the issuer exceed the issuer's available amounts. This rule is referred to in the regulations as the "proceeds-spent-last" rule – in that (except to the extent spent for *de minimis* working capital expenditures or extraordinary items as discussed below) bond proceeds are treated as spent only after the issuer's other available sources have been depleted.

To make sure the term of the working capital financing is not too long, the federal government requires the issuer to "soak up" future revenues as they become available either by paying off bonds over time or by taking other tax-exempt bonds off the market (which leads to roughly the same economic result as redeeming bonds). This process of using up future revenues is described in a regulatory safe harbor that is specific to long-term working capital financings. The safe harbor requires the issuer on the issue date to determine the first fiscal year (not more than five years from the issue date) in which it reasonably expects to have available amounts. This first fiscal year is referred to in the regulations as the "first testing year." Beginning with the first testing year and for each subsequent fiscal year for which the bond issue remains outstanding, the issuer must determine whether it has available amounts as of the first day of the fiscal year. Within the first 90 days of that fiscal year, the issuer must then redeem bonds with such available amounts or invest the available amounts in certain qualifying tax-exempt bonds.

Bond Proceeds Applied to *De Minimis* Working Capital

Apart from financings specifically to address short-term or long-term working capital needs, an issuer and borrower may apply certain *de minimis* rules to finance working capital expenditures as part of larger new money or refunding projects. Several types of costs that we commonly see in bond transactions are covered by this *de minimis* exception.

For example, all costs of issuance are allowed to be paid from proceeds of the bonds to which the costs relate (subject, of course, to the 2% costs of issuance limit that applies to private activity bonds), even costs of issuance that would not otherwise be considered capital expenditures. The same applies to qualified administrative costs such as brokerage commissions incurred to acquire temporary project fund investments, or to pay certain fees for bond insurance policies or swaps relating to the bonds from which the proceeds are to be taken. *De minimis* expenditures eligible for payment from bond proceeds also include arbitrage rebate payments or yield reduction payments for the issue of bonds from which the proceeds arise. This rule supports the use of proceeds to pay transferred proceeds penalties that may be relevant in refunding transactions or to reduce the yield on an investment in the event SLGS cannot be acquired.

In addition, the *de minimis* rules allow proceeds to be used to pay interest (funded interest) on the bond issue for up to three years from the issue date. The interest in this case must be interest on the bond from which the proceeds arise. Paying interest on another bond issue is not covered by this rule. This *de minimis* exception can be particularly meaningful to issuers seeking relief from operating expenses – interest payments that would otherwise be required to be paid by the issuer or borrower from operating funds can be funded from bond proceeds at least for an initial period after the bond issuance. We want to emphasize that this exception applies where interest payments are treated as working capital expenditures. No working capital exception is needed for using proceeds of bonds to pay interest (capitalized interest) that is properly capitalizable into the cost of a capital project and accrues while the project has not been placed in service yet.

Another available *de minimis* exception allows proceeds to be used to pay interest or principal on another issue to the extent there are unexpected excess sale or investment proceeds. Furthermore, investment earnings on a reserve fund that are deposited to a bond fund can typically be used to pay principal or interest on an issue. Finally, as a sort of "catch-all" provision, the regulations allow costs, other than costs already covered by one of the other *de minimis* exceptions, to be paid in an amount up to 5% of the sale proceeds of the bond issue as long as the costs are directly related to capital expenditures financed by the same issue. For example, this exception allows an issuer to pay initial operating expenses for a new capital project.

Even if an expenditure meets a *de minimis* exception above, the expenditure is not permitted from tax-exempt bond proceeds if, as a result of the expenditure, other moneys of the issuer are freed up and treated as replacement proceeds. Be sure to involve a member of the Public Finance Tax Group to determine whether this provision is relevant in the transaction being structuring.

Bond Proceeds Applied to Extraordinary Items

The regulations also allow tax-exempt bond proceeds to be applied to working capital expenditures that are for extraordinary, nonrecurring items. These items must not customarily be payable from current revenues. Examples include casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. Regular operating costs impacted by the COVID-19 coronavirus outbreak will not typically be considered costs for extraordinary items within the scope of this exception, even if such costs unexpectedly increase because of the outbreak.

Future Legislation and Guidance Relating to COVID-19

The provisions summarized in this publication reflect the bond-related tools that are currently available to address economic disruptions, including disruptions that may be caused by the COVID-19 coronavirus outbreak. Members of the Public Finance Tax Group have been working closely with other industry partners on efforts by the National Association of Bond Lawyers and the Tax-Exempt Financing Committee of the American Bar Association to request specific relief relating to the coronavirus outbreak. Requested relief would provide greater flexibility to access tax-exempt financing to fund operating deficits. We will continue to monitor federal legislation and regulatory actions and will keep you informed of any relevant developments.

Kutak Rock is helping clients stay informed and navigate rapidly evolving COVID-19-related news and federal and state policy in other legal areas, too. To stay informed, please visit our COVID-19 Legal Resources Portal.

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This memorandum was prepared by the national Public Finance Tax Group of Kutak Rock LLP. Questions, comments or corrections to this memorandum may be addressed to any of the attorneys listed below.

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