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WORKING CAPITAL FINANCINGS IN TIMES OF FISCAL DISTRESS – TAX CONSIDERATIONS

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I. What Is Working Capital?

A. The tax-exempt bond regulations define "working capital" as "any expenditure that is not a capital expenditure." Treas. Reg. § 1.150-1(b).

B. A "capital expenditure" is any cost of a type that, under general federal income tax principles, is properly chargeable to a capital account or would be so chargeable with a proper election.

II. Spending Proceeds on Working Capital -- "Proceeds-Spent-Last"

A. The general arbitrage rule provides that proceeds can be allocated to working capital expenditures only when there are no other "available amounts." Treas. Reg. § 1.148-6(d)(3). This rule is generally referred to as the "proceeds-spent-last rule."

B. Exceptions to the Proceeds-Spent-Last Rule.

1. General de minimis exception. Note that because certain of the following expenditures are or may be capital expenditures, the Draft ABA Comments recommend that the regulations be modified to eliminate any implication that these expenditures are necessarily working capital expenditures.

a. Issuance costs of the issue and qualified administrative costs. This exception is limited to issuance costs and qualified administrative costs for the issue financing the costs. The Draft ABA Comments recommend that this exception be revised to reference issuance costs of "an" issue rather than "the" issue.

b. Fees for qualified guarantees of the issue or payments for a qualified hedge for the issue. Like the exception for issuance costs above, the Draft ABA Comments recommend that this exception be revised by substituting "an" for "the" issue.

c. Interest on the issue through the later of three years from the issue date or one year after the date on which the project is placed in service. Note that interest on a capital financing issue through the placed-in-service date is a capital expenditure.

d. Rebate payments, yield reduction payments under Treas. Reg. §1.148–5(c) and payments of penalty-in-lieu-of-rebate under Treas. Reg. §1.148–7 for the issue.

e. Costs that do not exceed 5 percent of the sale proceeds of an issue and that are directly related to capital expenditures financed by the issue (e.g., initial operating expenses for a new capital project). Because of confusion caused by the "directly related" requirement, the Draft ABA Comments recommend that this requirement be eliminated as superfluous.

f. Principal or interest on an issue paid from unexpected excess sale or investment proceeds. Is there any limit on the use of this rule, e.g., where most of the financed project is cancelled and the majority of the proceeds become "excess"?

g. Principal or interest on an issue paid from investment earnings on a reserve or replacement fund that are deposited in a bona fide debt service fund.

2. Extraordinary items. Expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage, are not subject to the proceeds-spent-last rule. If, however, the issuer or a related party maintains a reserve for such items (e.g., a self-insurance fund) or has set aside other available amounts for such expenses, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

3. Exception for payment of principal and interest on prior issues. The proceeds-spent-last rule does not apply to refunding expenditures, i.e., expenditures for payment of principal, interest, or redemption prices on a prior issue and, for a crossover refunding issue, interest on that issue. Does the reference to "prior issue" preclude the use of proceeds to pay de minimis interest (and no principal) on another issue where that payment falls within the exception to a refunding issue?

4. Grants. Gross proceeds of an issue that are used to make a grant are allocated to an expenditure on the date on which the grant is made irrespective of whether the grant is to be used to fund capital expenditures or working capital expenditures.

C. Applying the Proceeds-Spent-Last Rule

1. Available amounts. Where the proceeds-spent-last rule applies, the issuer must determine whether there are moneys other than proceeds of the bonds (referred to as "available amounts") that could be spent for the working capital costs at the time of the expenditure. Available amounts include only those amounts that could be used by the issuer for working capital expenditures of the type being financed without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

a. Where no available amounts exist, it is not clear whether an actual allocation of proceeds to working capital expenditures is required, or alternatively that proceeds are deemed to be allocated to the expenditure. The Draft ABA Comments recommend that proceeds be deemed spent under these circumstances.

b. To what extent are "self-imposed" restrictions respected in identifying available amounts? In the investigations relating to Orange County, the SEC, which while not the final arbiter of tax matters may influence the views of bond counsel, took the position that such self-restriction is not effective for federal tax purposes, or at least creates a risk relating to the tax exemption of the debt, which should be disclosed. *In the Matter of Jean Costanza*, Securities Act of 1933 Release No. 7621. The IRS reached a similar conclusion in PLR 200846018 where it found "that the self-imposed restrictions on the use of the Fund (the "Transaction") is a transaction entered into for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of [Code] §148." Under what circumstances would self-imposed restrictions be respected?

c. In PLR 200446006, a state issued taxable bonds to pay the state's benefit obligations and to ensure sufficient capitalization of the state's unemployment trust account at a certain "floor" level. The state proposed in the ruling to convert one of its taxable issues into tax-exempt bonds upon a favorable ruling that proceeds of the taxable bonds were unavailable because the taxable bonds must be repaid. The IRS refused to so rule but concluded that, to the extent the taxable bonds funded amounts up to the required floor amount, the proceeds of such taxable bonds would properly be treated as unavailable. Under the approach of this ruling, it is not clear when or how proceeds of multiple issues can be treated as used to pay working capital expenditures. The Draft ABA

Comments recommend that proceeds of an issue (taxable or tax-exempt) not be treated as available amounts with respect to the issue of which they are proceeds or with respect to any other issue.

2. Working Capital Reserve. A reasonable working capital reserve is excluded from available amounts. The size of a working capital reserve is generally limited to the lesser of (a) 5 percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amounts is made (described in the regulations as including any expenditures, whether capital or working capital, that are paid from current revenues) and (b) the amount of a working capital reserve historically maintained by the issuer (to avoid the creation of other replacement proceeds by having the reserve treated as funded with bond proceeds).

   a. Technical Advice Memorandum 200413012 clarified that the base for the 5% limit (in (a) above) includes all working capital expenditures of the issuer in the prior fiscal year, including those working capital expenditures paid from the issuer's restricted funds that otherwise were not treated by the issuer as available. The Draft ABA Comments recommend that the IRS reverse the position expressed in this TAM so that the base for the 5% calculation is the issuer's prior year expenditures from available amounts.

   b. To determine the amount of a working capital reserve historically maintained by an issuer, the issuer may use the average amount maintained as a working capital reserve during annual periods of at least 1 year, the last of which ends within 1 year before the issue date. The regulations state that the average amount can, rather than must, be computed on a monthly basis.

      i. What other basis might be permitted, e.g., average of beginning and end of year, or lesser of beginning and end of year?

      ii. In calculating the average balance, most bond counsel appear to treat negative amounts as zero. Any other views?

      iii. Note that the requirement of having maintained a reserve is difficult for many issuers in financial distress to satisfy. (It may be possible to identify a historical reserve by looking back multiple years, which is unlimited by the regulations.) For this and other, technical reasons, the Draft ABA Comments recommend that this limit on the working capital reserve be eliminated.

3. Rebate exception spending rule. Under Code Section 148(f)(4)(B)(iii), the net proceeds of "tax or revenue anticipation bonds" (including earnings thereon) are treated as spent on the first day that the cumulative cash flow deficit to be financed by the issue exceeds 90% of the proceeds of the issue. This calculation requires a cumulative cash flow deficit equal to only 90% of the proceeds of the issue but does not permit the issuer to take a reasonable working capital reserve into account. No definition of tax or revenue bonds is provided. Also, the Code and regulations are silent as to whether meeting this statutory spending exception is sufficient, without also satisfying the regulatory spending exception, to treat all proceeds as spent for purposes of qualifying for the 13-month period described in III below.

III. Temporary Periods for Working Capital Financings

A. 13-month temporary period. Proceeds of a "restricted working capital expenditure" financing that are reasonably expected to be allocated to expenditures within 13 months after the issue date qualify for a 13-month temporary period. "Restricted working capital expenditures" expenditures subject to the proceeds-spent-last rule. Thus, under applicable Treasury regulations, the only temporary period that applies, for example, to financings for extraordinary working capital costs that qualify for the exception to the proceeds-spent-last rule is the general 30-day temporary period contained in Treas. Reg. § 1.148-2(e)(7).

B. A longer temporary period of up to two years applies to tax anticipation financings where the issuer expects to use tax levies from a single fiscal year to retire the issue but the collections require a longer time period. The temporary period ends on the earlier of two years after the date of issue or 60 days after the last date for the payment of the taxes without interest or penalty, but only if the issue matures by the end of the temporary period.

IV. Maturity Limitation and Other Replacement Proceeds.

A. Possible adverse consequences of allowing tax-exempt bonds to remain outstanding too long:

1. The bonds are determined to "overburden" the market thus becoming subject to the onerous rules of Treas. Reg. §1.148-10(b).

2. "Other replacement proceeds" may arise under Treas. Reg. §1.148-1(c)(4).

B. Treasury regulations.

1. Anti-abuse rule: "One factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under §1.148–1(c)(4)(i)(B)." Treas. Reg. §1.148-10(a)(4).

2. *"Other replacement proceeds—(i) Bonds outstanding longer than necessary -*

a. *In general.* Replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that—

i. The term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue, and

ii. There will be available amounts during the period that the issue remains outstanding longer than necessary.

Whether an issue is outstanding longer than necessary is determined under §1.148–10. Replacement proceeds are created under this paragraph (c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

b. *Safe harbor against creation of replacement proceeds.* As a safe harbor, replacement proceeds do not arise under paragraph (c)(4)(i)(A) of this section—

i. For the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than 2 years; . . . ."

Treas. Reg. §1.148-1(c)(4).

C. IRS Guidance: Notice 2001-49 and Rev. Proc. 2002-31. The two-year safe harbor described above appears to have been replaced with a 13-month safe harbor. The Draft ABA Comments recommend that this IRS guidance be revoked and that the two-year safe harbor apply.

D. PLR 9424043 (Richmond School District Ruling)

1. Proposed Financing: District in fiscal distress proposed to issue 30-year tax-exempt working capital bonds. The District satisfied the IRS that the District would not have available amounts during the first five years after issuance of the bonds. Thereafter, the District agreed to redeem bonds with any available amounts determined on an annual basis.

2. Rulings:

a. The bonds did not overburden the market provided the redemption covenant was satisfied.

b. No replacement proceeds of the bonds would arise from leaving the bonds outstanding too long provided the redemption covenant was satisfied.

c. No replacement proceeds of the bonds would arise on the basis that the proceeds were used to finance a working capital reserve.

E. Draft ABA Comment recommendations.

1. Bonds should not be considered outstanding longer than necessary if they are never outstanding in an amount that is greater than that which could be achieved with multiple issues of short-term bonds which themselves would not be considered outstanding longer than necessary.

   a. The issuer must reasonably expect to satisfy the above requirement.

   b. The issuer must have reasonable procedures in place to monitor whether the limits have in fact been met.

   c. If the issuer discovers that the financing exceeds the limits, it must promptly take an appropriate remedial action.

2. Application: To the extent the issuer reasonably expects as of a testing date (the “Projection Date”) it will have a traditional “available amounts” cash flow deficit sufficient to justify a short-term issue, the bonds would not be outstanding longer than necessary and there would be no other replacement proceeds. To the extent the issuer does not reasonably expect, on the Projection Date, to have a traditional available amounts cash flow deficit, the issuer would need to take a remedial action related to the amount of funds equal to the lowest positive balance of available amounts projected on the Projection Date (the “Excess Amount”).

   a. The Projection Date could be any date on which the issuer could issue new tax-exempt TRANs.

   b. The time between consecutive Projection Dates would be no more than thirteen months, and there must be a Projection Date during every fiscal year that the issue is outstanding.

   c. No other replacement proceeds will arise if, during a given year, the issuer reasonably expects to have a sufficient traditional available amounts cash flow deficit.

   d. If the issuer does not expect such a deficit, the issuer must take a remedial action with respect to the Excess Amount.

   e. Investment in non-AMT bonds should be permitted as an alternative remedial action to redeeming bonds. The same rules as those applicable under the Code section 149(g)(3)(B) hedge bond rules should apply: requirement to invest 95% of the Excess Amount in non-AMT bonds; and 30-day grace period to reinvest. Variable rate demand deposit SLGS and mutual funds that historically invest exclusively in non-AMT bonds should be treated as non-AMT bonds. This investment requirement would apply until the earlier of: an actual deficit that allows the Excess Amounts to be treated as spent on a proceeds-spent-last basis; 90 days after the next Projection Date; or use of the Excess Amount to pay capital expenditures.

   f. Actual redemption of bonds or investment in non-AMT bonds should not be required less than 90 days after the Projection Date.

3. New category of bonds called “budget deficit working capital bonds.”

   a. In general, if a working capital bond issue meets the duration and amount limitations, an issuer would not be required to test for other replacement proceeds or to determine whether the bonds constitute an overburdening.

   b. To utilize the provisions for budget deficit working capital bonds, issuers must establish an actual or expected budget deficit.

   c. Specific durations for the budget deficit working capital bonds are proposed based on the size of the deficit, recognizing that a longer recovery period is necessary for more sever budget problems. These limitations would be provided as a safe harbor or an alternative to a long-term bond issue incorporating a procedure for annual testing and remediation of any overburdening. For budget deficits: not exceeding [3] percent of annual revenues, bonds may be outstanding no longer than [5] years without a requirement for annual testing and possible remediation; more than [3] percent of annual revenues, bonds may be outstanding up to [10] years; more than [7] percent of annual revenues, bonds may be outstanding no longer than [15] years; and more than [10] percent of annual revenues, bonds may be outstanding up to [20] years.

   d. Because the provisions are intended as a safe harbor, a limitation of 30 percent of the actual working capital expenditures of the issuer in the prior fiscal year is proposed as an overall limit on the aggregate principal amount of budget deficit working capital bonds that may be outstanding at any one time.

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