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Working Capital Financings: Federal Tax Law Considerations

Introduction

Catastrophic storms in Vermont led to widespread flooding and the resulting need for clean-up and repairs may cause financial strain on many local governments. This paper is written to address questions that have arisen regarding the use of tax-exempt bonds to finance working capital expenditures. These questions include whether the expenditures can be financed on a tax-exempt basis, when the proceeds are treated as "spent" for tax purposes, how the proceeds can be invested until spent, and how long the borrowing can remain outstanding.

For tax purposes, a "working capital expenditure" is defined as "any cost that is not a capital expenditure."[1] And a "capital expenditure" is defined as "any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election . . .) under general Federal income tax principles."[2] In general, a capital asset must have a useful life in excess of one year. Costs incurred for operational and other non-capital purposes, such as salaries and utilities, are generally working capital costs. The Treasury Regulations (the "Regulations") promulgated in connection with the Internal Revenue Code of 1986, as amended (the "Code") provide certain restrictions on the use of tax-exempt financing for working capital purposes.

Can working capital be financed on a tax-exempt basis?

There are limits on the ability to finance working capital expenditures on a tax-exempt basis. Generally, governmental bond proceeds may be used to finance working capital, particularly in times of financial distress, provided that certain requirements are met, as further described below. Historically, government issuers have commonly undertaken short-term borrowings to finance cash flow imbalances within a fiscal period but long-term working capital borrowings were rare, primarily because they were thought to be fiscally imprudent and often raised state authorization questions and federal tax questions. However, with the financial distress caused by the widespread flooding, long-term working capital financing may be utilized more broadly by Vermont governmental entities (collectively, referred to as "issuers" herein).

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[1] Treas. Reg. §1.150-1(b).
[2] Ibid.

When are proceeds used for working capital expenses considered "spent" for tax purposes?

The general rule is that, unless an exception applies, proceeds used to finance working capital costs are "spent" only when there are no other "available amounts". This is referred to as the "proceeds-spent-last rule" and means that the proceeds, including any investment earnings, cannot be considered spent until the issuer actually experiences a cash flow deficit within the requisite time frame. By contrast, proceeds may be allocated to capital expenditures using any reasonable, consistently applied method, including a gross proceeds spent first method.[3] Working capital costs that do not qualify for an exception to the "proceeds-spent-last rule" are referred to as "restricted working capital".

"Available amount" is defined as "an amount that is available to the issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of any issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed."[4] Note that moneys held by related persons (i.e., part of the same controlled group) may be considered available for this purpose. When determining the available amounts, a reasonable working capital reserve can be excluded. A working capital reserve is reasonable if it does not exceed 5% of the actual working capital expenditures of the issuer in the prior fiscal year. For this purpose, any expenditures (capital or working capital) paid out of current revenues may be treated as working capital expenditures.[5] Accordingly, the proceeds are spent as and to the extent that the issuer's expenses exceed the revenues and other available amounts less the 5% working capital reserve. As an example, an issuer with $100x in prior fiscal year expenditures paid out of current revenues can exclude $5x from available amounts as a reasonable working capital reserve. So if the issuer has $20x in available cash and investments, it can treat the proceeds as starting to be spent once its expenses exceed $15x. Bond proceeds not treated as spent under this methodology continue to be treated as unspent proceeds for tax purposes, even if they can be traced directly to working capital expenditures. The available amounts are deemed to have been spent first, before the proceeds.

There are several exceptions to the "proceeds-spent-last rule" for de miminis working capital expenditures, **extraordinary items** and the payment of principal and interest on prior issues.

The de minimis exceptions ("de minimis working capital") include costs of issuance and costs of acquiring purpose and nonpurpose investments, qualified guarantee or qualified hedge fees, interest on the issue for a period of up to three years from the issue date or, if later, one year after the date on which the project is placed in service[6], rebate or yield reduction payments, working

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[3] Treas. Reg. §1.148-6(d)(1)(i).
[4] Treas. Reg. §1.148-6(d)(3)(iii)(A).
[5] Treas. Reg. §1.148-6(d)(3)(iii)(B).
[6] Note that construction period interest is a capital cost.

capital expenses directly related to capital expenses being financed with the issue in an amount of up to 5% of the sale proceeds of the issue, unexpected excess sale or investment proceeds used to pay principal or interest on the issue, and principal or interest paid from earnings on a reserve fund.[7]

The exception for "extraordinary, nonrecurring items that are not customarily payable from current revenues" includes casualty losses and extraordinary legal judgments in excess of insurance coverage, which may be particularly helpful for the working capital costs related to flooding damage. 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 may only be allocated after the available amounts in the reserve are expended. If this exception applies, the issuer may allocate the bond proceeds to the working capital expenditures even if other moneys would be available to make the expenditure.

None of the exceptions apply, however, if the use of the proceeds gives rise to replacement proceeds. For example, in the case of a failed reimbursement allocation, the regulations provide that the use of proceeds to instead pay interest on an issue that would otherwise have been paid from the issuer's current revenues may result in replacement proceeds.

How can the proceeds be invested until spent?

Proceeds of an issue that are reasonably expected to be allocated to working capital expenditures within 13 months of the issue date are subject to a 13-month temporary period,[8] during which the proceeds may be invested at a yield that exceeds the bond yield. However, a three-year temporary period applies to "certain working capital expenditures that are treated as part of a capital project."[9] "Capital project" is defined to include "related working capital expenditures to which the de minimis rule under § 1.148-6(d)(3)(ii)(A) applies, that carry out the governmental purpose of an issue."[10] Accordingly, bonds financing de minimis working capital are subject to the three-year temporary period but bonds financing restricted working capital are subject to the 13-month temporary period. If restricted working capital expenditures are not expected to be spent within 13 months, they will not qualify for a temporary period and will be subject to yield restriction from the issuance date.

If a temporary period applies, the investment proceeds during the temporary period that exceed the bond yield will need to be rebated to the United States unless an exception to rebate applies. For working capital financings, no rebate is due if all bond proceeds are spent pursuant to the "proceeds-spent-last rule" within six months of the issue date.[11] Issuers generally want to invest the proceeds of a working capital borrowing at an unrestricted yield until they are spent and to retain any arbitrage profits that they are able to earn from the investment. In order to optimize

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[7] Treas. Reg. §1.148-6(d)(3)(ii)(A).
[8] Treas. Reg. §1.148-2(e)(3).
[9] Ibid.
[10] Treas. Reg. § 1.148-1(b).
[11] I.R.C. §148(f)(4)(B).

their ability to do so, these issuers will size a working capital borrowing to be no greater than the maximum cumulative deficit reasonably expected to occur within six months after the issuance of the bonds. Failure to actually achieve the expected deficit within six months after issuance will mean that the bond proceeds have not been fully spent and therefore the bonds have not satisfied the 6-month rebate exception and, accordingly, any positive investment arbitrage will have to be rebated to the United States. As a practical matter, the positive arbitrage amount can be difficult to determine because the proceeds have often been commingled and determining the investment yield may be challenging and require adequate record keeping. In addition, if the proceeds are not treated as spent within six months of the issue date, there will be an ongoing arbitrage problem so long as the issue is outstanding, trying to determine whether and to what extent the proceeds can be treated as spent.

How long can a working capital borrowing be outstanding?

Short-term working capital financings can be outstanding for up to 13 months. There is no clear guidance as to how long a long-term working capital financing can be outstanding. Anti-abuse regulations[12] impose serious burdens on issues if tax-exempt bonds are considered outstanding longer than necessary for the governmental purpose of the issue, including the need to yield restrict every investment of bond proceeds separately, the application of the proceeds-spent-last rule to all capital and working capital expenditures, and no longer permitting the exclusion of a working capital reserve in calculating available amounts.

Cash amounts accumulated by the issuer of working capital bonds can become subject to the replacement proceeds definition based on how long the issue is outstanding.[13] Replacement proceeds are funds of an issuer that are treated as bond proceeds for tax purposes, and therefore subject to various tax law limitations. There are two safe harbors against the creation of replacement proceeds. The first is a 13-month maturity safe harbor. Short-term deficits that are not expected to persist for more than a fiscal year may be financed on a tax-exempt basis with bonds that mature within 13 months. The second is a long-term working capital safe harbor. For issuers experiencing severe financial distress that is expected to persist for longer than a fiscal year, bonds may have longer maturities but the issuer must meet certain requirements. On the issue date, the issuer must determine the first fiscal year in which it reasonably expects to have available amounts for working capital expenditures. That will be the first testing year and cannot be later than five years after the issue date. Beginning on the first day of the first testing year and continuing each fiscal year thereafter while the bonds are outstanding, the issuer must calculate the available amounts and apply such amounts within 90 days to either repay the bonds or purchase other tax exempt bonds (including tax-exempt, non-AMT bonds or SLGS). The effect of these rules is to require issuers to compete complicated analyses of their projected budgets both before the bonds are issued and periodically thereafter.

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[12] Treas. Regs. §1.148-10(b).
[13] Treas. Regs. §1.148-1(c)(4).

Meeting the safe harbor against the creation of replacement proceeds also prevents the bonds from being attacked as an abusive arbitrage device under the regulations.[14] Those regulations provide that bonds are arbitrage bonds, and therefore taxable, if the bonds overburden the tax-exempt bond market. One factor in whether an issue overburdens the tax-exempt bond market is if the bonds are outstanding longer than reasonably necessary to accomplish the governmental purpose of the issue. The regulations provide that "[o]ne factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds. . ." However, the regulations go on to say that "[t]hese factors may be outweighed by other factors, such as bona fide cost overruns, an issuer's bona fide need to finance extraordinary working capital items, or an issuer's long-term financial distress."

The preceding is an overview of the federal tax law rules pertaining to financing working capital expenditures with tax-exempt bonds. Please call Christie Martin at (617) 348-1769 if you have additional questions.

[14] Treas. Regs. §1.148-10(a)(4).

Federal Tax Consideration for Financing Flood Clean-Up

Decision Tree

[See memo for additional details, including avoiding replacement proceeds]