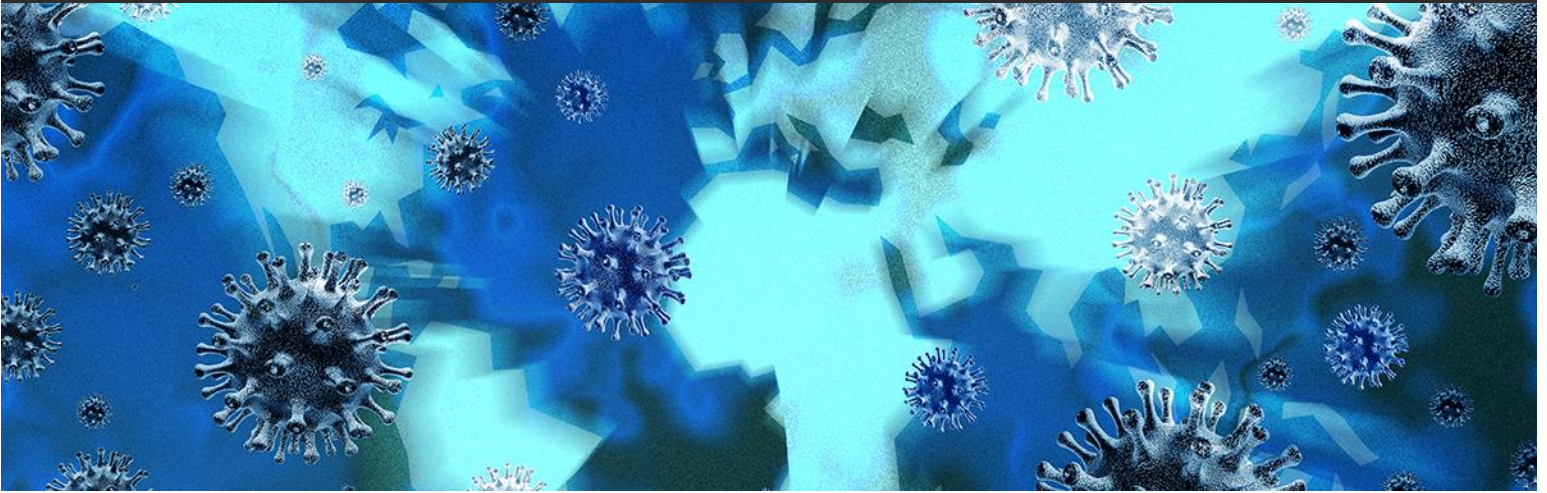


**Alert | Health Emergency Preparedness Task Force:
Coronavirus Disease 2019**



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Tax-Exempt Bond Tools for Governments Facing Cash Flow Challenges

With their taxpayers facing financial difficulties from Coronavirus Disease 2019 (COVID-19), state and local governments may in turn face temporary cash flow disruptions. To alleviate these disruptions, governmental entities may want to consider short term tax-exempt working capital financings permitted by the Internal Revenue Code of 1986, as amended (the Code). Revenue Anticipation Notes (RANs) or Tax Anticipation Notes (TANs, collectively, TRANS) are designed to cover short-term mismatches between revenues and expenses. Some governmental entities use these tools on a regular basis, but others may be missing out, particularly now, on the benefits of these tools. This Alert is intended to help governmental entities avail themselves of these short-term borrowing options.

The Concept

Every state and local government assesses and imposes taxes, whether sales taxes, *ad valorem* property taxes, wage taxes, or personal and business income taxes. Some of these taxes produce cash flow reasonably consistently through the year. Others come in in large, predictable receipts. State and local governments also receive other revenue, some on a predictable schedule, some not. Every state and local government has rather predictable working capital costs, the timing of which may not vary as much as the timing of its revenue receipts. This mismatch creates a need for short-term borrowing to pay budgeted expenses before the budgeted revenues are received; a need that may be met with TRANS.

When the economy grinds to a sudden halt, state and local governments are forced to reevaluate their budgets and their related cash flow needs and expectations and may determine that they would benefit from a short-term working capital borrowing in anticipation of revenue to be received later. For example, these entities may defer the timely payment of taxes causing a mismatch between revenues and expenses not previously experienced. This is another potential use for TRANs.

Additional incentive for issuing TRANs may be the added liquidity feature offered by the Federal Reserve. As discussed in an April 10 [GT Alert](#), the Board of Governors of the Federal Reserve System launched a Municipal Liquidity Facility, which will purchase up to \$500 billion of TRANs and other short-term notes from states and certain local governments.

Applicable Rules

Governmental Purpose

Borrowing to meet cash flow requirements of a governmental operations budget is a governmental purpose that generally may be financed with tax-exempt bonds. The rules that limit the ability of a state or local government to borrow for working capital needs are the rules related to arbitrage and rebate.

The Arbitrage and Rebate Rules

The arbitrage rules restrict how many bonds may be issued, when they may be issued, and how long they may remain outstanding. If too many bonds are issued, or if bonds are outstanding longer or issued earlier than they are needed, the bonds will be treated as an over-issuance and will be taxable arbitrage bonds (the Over-Issuance Rule).

Additionally, two arbitrage rules place investment restrictions on proceeds of the bonds and certain other amounts. The first rule generally restricts the yield on unspent proceeds of the bonds and on amounts available to repay the bonds (collectively, gross proceeds) to a yield that is not materially higher than the yield on the issue (the “Yield-Restriction Rule”). The second rule generally requires that in most circumstances investment earnings above the yield be “rebated” or paid to the U.S. Treasury (the Rebate Rule). Typically, if gross proceeds of a tax-exempt bond are subject to the Yield-Restriction Rule, they will not be invested at a return that generates a rebate obligation under the Rebate Rule. Because in some investment environments it may be difficult to invest gross proceeds below the yield on the issue, the Yield-Restriction Rule permits higher yielding investments during the period when the gross proceeds would be expected to be spent or held (each, a temporary period). During these “temporary periods” there may be excess investment earnings that will be subject to the Rebate Rule, unless an exception to the Rebate Rule applies.

How the Rules Apply to TRANs

The Over-Issuance Rule limits when, how much, and for how long a state or local government may borrow for working capital purposes on a tax-exempt basis. Under this rule, a bond that qualifies for a “temporary period” under the Yield Restriction Rule will not violate the Over-Issuance Rule. However, in applying the Over-Issuance Rule, as well as in applying the Yield Restriction Rule and the Rebate Rule, the Code treats tax-exempt proceeds as spent on working capital only if there are no other amounts available to be spent for such purpose (the Proceeds Spent Last Rule). Each of the applicable rules is explored below.

Under the Yield Restriction Rule, an issuer that issues a TRAN may benefit from a 13-month “temporary period” during which the issuer may invest the proceeds of the TRAN at an unrestricted yield provided

that the proceeds of the TRAN are expected to be used for expenses within 13 months. A longer period of two years is permitted for TANS if (a) the TAN is reasonably expected to be paid from tax revenues from one fiscal year, and (b) the TAN matures by the earlier of two years or 60 days after the last date for timely payment of those taxes. Under the Rebate Rule, there is an exception that permits an issuer to keep arbitrage earned if all gross proceeds are spent within six months of the issue date. There is also statutory safe harbor for determining if the TRAN meets the six-month exception to the Rebate Rule. That safe harbor (the Six Month Safe Harbor) applies if the actual cumulative deficit, as described below, exceeds 90 percent of the proceeds of the TRANs within six months after issuance.

Under the Proceeds Spent Last Rule, proceeds will be treated as spent for working capital expenditures only after other available amounts (in the case of working capital expenditures, revenues and taxes available for that purpose) are spent. To apply this rule, a governmental entity must consider its expected available revenues (including any amounts unspent from the prior year) and expected expenditures to determine the amount of cash flow deficit that may be financed with a TRAN. In making this computation, the issuer generally is permitted to disregard a reasonable working capital reserve, generally equal to 5 percent of the prior fiscal year's actual working capital expenditures. However, in applying the Six Month Safe Harbor to rebate, a governmental entity is not permitted to disregard a reasonable working capital reserve.

The small issuer exception to the Rebate Rule may also apply. Ordinarily, this rule applies if the governmental entity reasonably expects, as of the issue date, that it will not issue during the calendar year more than an aggregate face amount of tax-exempt governmental bonds of \$5 million, or the issuer does not in fact issue more than such amount during the calendar year.

Additionally, a TRAN will not be considered outstanding longer than is reasonably necessary, under the anti-abuse rules in the regulations, if the final maturity date is not later than the applicable temporary period, generally 13 months.

Computation Example

Governmental entity has \$2 million available cash for working capital expenditures at the start of the fiscal year. Its prior year's actual working capital expenditures were \$33 million, which means the governmental entity may set aside a reasonable working capital reserve of \$1.65 million (5% x \$33 million), which it will finance from the \$2 million available cash. The governmental entity receives a small portion of its revenues throughout the year, but generally it receives its tax revenues in Months 2 and 3. In this hypothetical, the governmental entity permits taxpayers an additional 90 days to timely pay taxes to accommodate financial difficulties that its taxpayers are facing from COVID-19 shutdowns. The entity also expects more late payment of taxes than in prior years, resulting in a large portion of taxes expected to be received in Month 7. Thus, most of the tax revenues will be received in Months 5 and 6, leaving the governmental entity with significant cash shortfall in Months 2 and 3. The governmental entity intends to finance that shortfall with TRANs that is issues in Month 1 and that matures in Month 11.

Month (fiscal year Month 1- Month 12)	Projected Revenues (received on first of month) excluding TRAN receipts	Projected Expenses (paid on first of month) excluding sinking fund payments on TRANS	Projected Cumulative Cash Flow Surplus or (Deficit)	Actual Cash Flow Surplus or (Deficit)
Start of fiscal year-opening balance	\$2,000,000 minus working capital reserve \$1,650,000	N//A	N/A	\$2,000,000
Month 1	\$700,000	\$1,300,000	(\$250,000)	\$1,400,000
Month 2	\$700,000	\$12,000,000	(\$11,550,000)	(\$9,400,000)
Month 3	\$1,000,000	\$17,000,000	(\$27,550,000)	(\$25,250,000)
Month 4	\$1,200,000	\$2,000,000	(\$28,350,000)	(\$26,050,000)
Month 5	\$15,000,000	\$4,000,000	(\$17,350,000)	(\$15,650,000)
Month 6	\$20,000,000	\$3,000,000	(\$350,000)	(\$332,000)
Month 7*	\$5,000,000	\$3,000,000	\$1,650,000	\$1,418,000
Month 8	\$1,500,000	\$800,000	\$2,350,000	\$2,168,000
Month 9	\$700,000	\$1,200,000	\$1,850,000	\$1,568,000
Month 10	\$850,000	\$1,000,000	\$1,700,000	\$1,893,000
Month 11	\$700,000	\$1,000,000	\$1,400,000	\$1,458,000
Month 12	\$1,000,000	\$1,000,000	\$1,400,000	\$1,433,000
Month 13	\$750,000	\$700,000	\$1,450,000	\$1,358,000
Totals	\$49,100,000 plus \$350,000 from available revenues at start \$49,450,000	\$48,000,000	N/A	N/A

*First day of Month 7 is last date for payment of taxes without interest or penalties.

The largest cumulative cash flow deficit is projected to occur in Month 4 and is \$28.35 million. Accordingly, the governmental entity may issue up to \$28.35 million in proceeds of a TRANs issue. Because the largest projected deficit occurs in Month 4, the proceeds of the TRANs issue are reasonably

expected to be spent within 13 months of the issue date of the TRANs and, therefore, satisfies the 13-month temporary period under the Yield Restriction Rule and is expected to meet the six-month general exception to the Rebate Rule (and to meet the Six Month Safe Harbor). Further, because the TRANs will be redeemed in Month 11, they will not be outstanding longer than the 13-month temporary period and will not be arbitrage bonds under the Over-Issuance Rule.

The furthestmost right column shows the actual cash flow deficit, which is ultimately smaller than projected and, in this scenario, the TRANs issue would not satisfy the general six-month exception to Rebate, but meets the Six Month Safe Harbor. Because it meets the Six Month Safe Harbor, the issuer of the TRANs issue would be permitted to keep any arbitrage made with respect to the TRANs.

For more information and updates on the developing COVID-19 situation, visit [GT's Health Emergency Preparedness Task Force: Coronavirus Disease 2019](#).

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