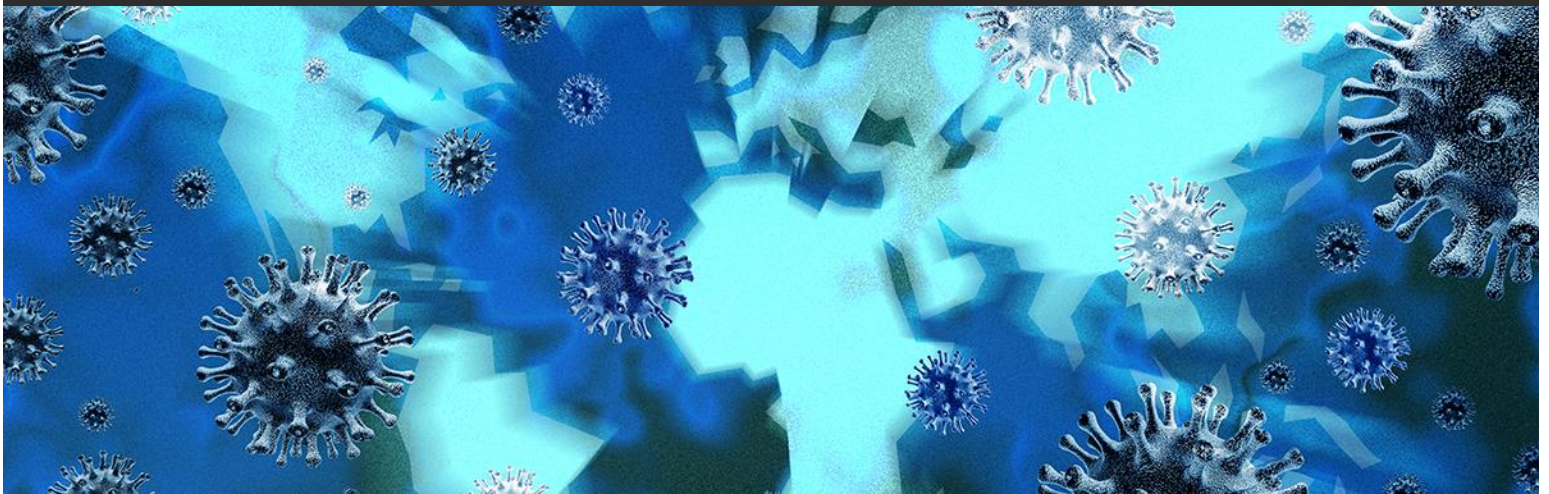


**Alert | Health Emergency Preparedness Task Force:
Coronavirus Disease 2019**



June 2020

Tax-Exempt Bond Tools for Governments Facing Cash Flow and Revenue Challenges – Part II

The Coronavirus Disease 2019 (COVID-19) continues to have a significant financial impact on state and local governments (Issuers). Issuers have not only had to defer the deadlines for taxes owed to them by their taxpayers, but they also still face lower tax and other revenues and increased expenses, possibly for years to come. In an [April 2020 GT Alert](#) (Prior Alert), we discussed how Issuers could use tax and revenue anticipation notes (TRANS) to address mismatches in revenues and expenses generally within a single fiscal year, such as mismatches arising from granting their taxpayers a several-month deferral of taxes. Issuers facing reduced tax and other revenue and increased expenses due to COVID-19 could require a much longer-term working capital borrowing. This GT Alert supplements our Prior Alert, discussing special considerations for long-term working capital tax-exempt bonds.

Rules Reviewed in the Prior Alert and How Those Rules Apply to Longer-Term Working Capital Obligations

As with all tax-exempt bonds, there are rules that govern tax-exempt obligations issued to finance working capital. Our Prior Alert discusses how certain of these rules apply to working capital obligations. Those rules are highlighted below.

1. **Use of Proceeds.** Generally, Issuers are permitted to issue governmental obligations for their own working capital purposes. An Issuer may also be able to issue an obligation and loan the proceeds to an exempt organization for its working capital purposes; these obligations are subject to additional rules not addressed in this Alert.
2. **Proceeds-Spent-Last Rule.** This rule permits an Issuer to treat proceeds of its working capital obligation as spent only after all other amounts that the Issuer has available for working capital expenditures are spent. The Prior Alert provides details and an example on how this rule applies. This rule applies to all working capital obligations.
3. **Arbitrage Yield Restriction Rule.** This rule prohibits an Issuer from investing gross proceeds of the working capital obligation in higher yielding investments. For working capital obligations of the type discussed here, there is an exception if the Issuer reasonably expects to spend the proceeds – using the Proceeds-Spent-Last Rule – within 13 months of issuance, known as the Yield Restriction Temporary Period. If an Issuer does not reasonably expect to spend the proceeds within 13 months, it must restrict the yield on investments acquired with gross proceeds to essentially the yield on the obligation. Because longer-term working capital obligations in today’s environment may be quickly spent, even under the Proceeds-Spent-Last Rule, an Issuer may meet the Yield Restriction Temporary Period for those obligations.
4. **Arbitrage Rebate Rule.** This rule generally requires positive investment earnings on proceeds of working capital obligations that are invested pending expenditure to be paid to the United States. There are exceptions that apply if the Issuer spends the proceeds – using the Proceeds-Spent-Last Rule – within six months of issuance, or meets the safe harbor, which generally requires most proceeds to be spent within a six-month period. For working capital obligations that do not meet an exception, the Issuer will be required to rebate investment earnings to the United States to prevent interest on the obligation from being taxable. As noted above, the proceeds of a longer-term working capital obligation may be spent quickly and can meet the exceptions to the Arbitrage Rebate Rule as well.
5. **Overissuance Rule.** This rule prohibits a working capital obligation from being outstanding longer than necessary, from being issued earlier than necessary, or from being issued in an amount that is larger than necessary, for the governmental purpose of obligation working capital expenditures. This rule is generally applied by looking at all the facts and circumstances; however, meeting certain rules, such as a Yield Restriction Temporary Period, factors favorably in the analysis. As noted in the Prior Alert, a short-term working capital obligation that satisfies the Yield Restriction Temporary Period should not create an overissuance concern because the proceeds are spent soon after it is issued, and it is redeemed soon thereafter. However, longer-term working capital obligations meeting the Yield Restriction Temporary Period may, nevertheless, raise a question about whether they are outstanding longer than necessary because of their longer maturity. There is an additional rule to consider in that case. That rule generally provides that failing to meet the safe harbor against creation of replacement proceeds, discussed below, may indicate that the obligation is outstanding longer than necessary.

Additional Rules to Consider with Longer-Term Working Capital Obligations

Replacement Proceeds Rule

When an Issuer considers a working capital obligation that will be outstanding longer than 13 months – or two years for certain tax anticipation notes – it must consider whether additional proceeds will be

attributed to the obligation under the replacement proceeds rule. Replacement Proceeds are monies other than proceeds of the tax-exempt obligation that are nevertheless treated as proceeds because they have a sufficient nexus to the governmental purpose (the working capital expenditures) to conclude that those amounts would have been used for those expenditures if the tax-exempt obligation was not used for the governmental purpose. As proceeds of the obligation, replacement proceeds will be subject to tax-exempt bond rules such as the arbitrage rules.

The Treasury and the IRS have created a safe harbor (the Safe Harbor) against the creation of replacement proceeds for long-term working capital obligations. The Safe Harbor requires the Issuer, on the date that it issues the tax-exempt obligation, to determine the first fiscal year in which it reasonably expects to have available amounts for working capital expenditures and will test for such available amounts. In no event may this “first testing year” begin more than five years from the issue date. This “first testing year” will be the first fiscal year in which the Issuer must test for available amounts. For each fiscal year in which the bonds remain outstanding, beginning with the first testing year, the Issuer must determine the available amounts as of the first day of such fiscal year. If there are available amounts, the Issuer must do one of the following with those amounts within 90 days of the start of that fiscal year: (1) redeem bonds or (2) invest in certain qualifying tax-exempt bonds. In determining the amount to redeem or invest, the Issuer may treat amounts used for expenditures during the first 90 days of that fiscal year and a bona-fide debt service fund as unavailable. An Issuer that has invested available amounts in tax-exempt obligations to satisfy the Safe Harbor may sell those obligations, provided that the proceeds from the sale are used within 30 days for a governmental purpose for which there are no other available amounts, or to redeem eligible tax-exempt bonds.

Hedge Bond Rules

Issuers of longer-term working capital obligations should also pay attention to the Hedge Bond Rules. Under the Hedge Bond Rules, an obligation is treated as a hedge bond and is a taxable bond unless it meets certain requirements relating to how quickly the proceeds are reasonably expected to be spent, and how the proceeds are invested prior to expenditure. Under this rule, generally, working capital obligations may be categorized as taxable unless:

- At least 85% of the proceeds are spent under the Proceeds-Spent-Last Rule.
- Those proceeds are spent within three years of issuance.
- Not more than 50% of the proceeds are reasonably expected to be invested pending expenditure for the governmental purpose, in an investment with a guaranteed yield for four years or more.

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

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