

# **Bond Case Briefs**

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## **Federal Tax Law Considerations for Financings COVID-19 Costs on a Tax-Exempt Basis: What Issuers Need to Know - Orrick**

States, municipalities and 501(c)(3) organizations (Issuers) likely will have to incur significant expenses in their fight against COVID-19. Even if Issuers have reserves available for these costs, there are a few different avenues to financing these expenses on a tax-exempt basis. The federal tax limitations relating to capital and working capital financing are discussed in the FAQs below, including using long-term, tax-exempt debt to finance short lived capital assets or working capital expenditures.[1]

### **CAPITAL EXPENDITURES**

When financing capital expenditures made to fight COVID-19, are there any special considerations to take into account?

Issuers likely will incur significant capital costs during their fight against COVID-19. These expenses may include the purchase of equipment and construction of improvements. All such costs may be financed on a tax-exempt basis, but the federal tax law generally limits the maximum term of the borrowing to only a few years for short-lived assets or assets that will only be owned and used by the Issuer for a short period of time before being decommissioned or sold. Note that supplies, such as hospital personal protective equipment, are treated differently, as discussed below. Construction costs for temporary facilities need to be addressed on a case by case basis.

### **What if an Issuer is buying a lot of short-lived assets?**

It is likely that Issuers will be buying large quantities of COVID-19 fighting equipment at the same time revenues will be drastically reduced. Accordingly, there may be a benefit to such entities to be able to finance their purchases on a long-term basis. There are a few strategies that allow for longer term financing of short useful life assets. One strategy is to combine short and long-life assets in the same tax-exempt financing, because the tax law maturity limitation compares the average maturity of bonds to the average useful life of the financed assets. See the Reimbursement Resolutions and Lines of Credit discussions immediately below. Another strategy is to treat the transaction as a long-term working capital financing, discussed further below, but that strategy only works for governmental purpose bonds.

*Reimbursement Resolutions* -All Issuers with these expenditures should adopt reimbursement resolutions as soon as possible. This will allow the Issuer to finance the expenditures at a later date. One strategy for extending the average maturity of bonds is to combine the reimbursement for expenditures for short-lived assets with expenditures for long-lived assets. Reimbursement resolutions do not obligate an Issuer to issue bonds, but reimbursement resolutions will preserve the ability of the Issuer to do so if later desired. Without a reimbursement resolution, an Issuer may not be able to finance prior expenditures on a tax-exempt basis.

*Lines of Credit* - Issuers may consider short-term lines of credit, or increasing capacity under existing lines of credit, in an effort to better manage cash flow in the coming months. Issuers that

use lines of credit (whether taxable or tax-exempt) may allocate draws under the line to capital expenditures and refinance such draws on a tax-exempt basis in the future. However, the Issuer will have to allocate draws on the line to capital expenditures no later than 60 days after the expenditure. See more information on this topic [here](#). By preserving the ability to finance these costs at a later date, the refinancing of short-lived assets can be combined with a financing for long-lived assets.

### **What if an Issuer will only need to use the financed assets for a short period of time?**

It is reasonable to assume that many of the assets being purchased to fight COVID-19 will be decommissioned from use at some point and will be put into reserves so that they may be recommissioned during the next emergency. These assets may be financed with tax-exempt bonds on the same basis as if the Issuer expected to use the assets for their intended purpose continuously. Assets stored in a strategic reserve are considered to be used appropriately for federal tax law purposes.

### **What if an Issuer wants to sell the financed assets after the crisis is over?**

Tax-exempt financed capital assets purchased for use for a short period of time with the expectation that the assets will be sold are subject to a different analysis depending if the assets were financed with governmental purpose bonds or qualified 501(c)(3) bonds.

#### *Governmental Purpose Bonds*

Generally, such assets may be financed with governmental purpose bonds if on the date the bonds are issued the Issuer reasonably expects it will sell few enough assets to fit within certain de minimis limitations or the Issuer meets a specialized rule. The rule requires that:

1. The municipality reasonably expects, as of the issue date, that the financed property will be used appropriately for a substantial period before the sale;
2. The municipality is required to redeem all the related bonds within 6 months of the sale;
3. The municipality has not arranged for the sale of the assets as of the issue date; and
4. The sale is for a fair market value price (and certain other technical and minor requirements).

Issuers should consult their Orrick tax counsel early in the financing process so that the specific tax requirements that apply to each situation may be determined.

#### *Qualified 501(c)(3) Bonds*

Unlike governmental purpose bonds, all property financed with the proceeds of qualified 501(c)(3) bonds must be owned by a state or local governmental entity or a 501(c)(3) entity for the entire time the bonds are outstanding. Accordingly, tax-exempt qualified 501(c)(3) bonds generally should not be used to finance the purchase of capital assets that are intended to be used for a short period of time and sold unless the final maturity of the bonds is at the same time as, or occurs before, the sale of the asset.

### **May personal protection equipment (PPE) be financed on a tax-exempt basis?**

Given the current urgent need for personal protective equipment (PPE) that is being experienced by our healthcare providers, it is important to talk about PPE. PPE includes gloves, masks, gowns and other such equipment that is used up quickly and does not have an expected useful life of more than one year. In fact, much of the PPE is considered single use only. Accordingly, PPE is considered a supply item rather than a capital asset and therefore expenditures made for PPE are considered working capital expenditures, which are discussed in more detail below.

## WORKING CAPITAL EXPENDITURES

### **May working capital expenditures be financed on a tax-exempt basis?**

The ability to issue tax-exempt bonds for working capital expenditures is limited. Generally, these financings fall into one of three categories:

1. Capital financings that include a de minimis amount of working capital (no more than 5% of the bond proceeds) that are directly related to the capital expenditures being financed;
2. Financing cash flow deficits (short-term or long-term); and
3. Financing extraordinary, nonrecurring working capital expenditures.

We will limit this discussion to deficit financings and financings for extraordinary working capital expenditures. Note that the discussion below applies to 501(c)(3) organizations as well as state and local government entities.

### **What options are available to finance a short-term cash flow deficit?**

Short-term deficits that are not expected to persist for more than a fiscal year may be financed on a tax-exempt basis with short-term notes that have a maturity not in excess of 13 months. This is the typical tax revenue anticipation note (TRAN) or revenue anticipation note (RAN) transaction.

Generally, the maximum size of these financings is limited by the size of the deficit plus a reasonable working capital reserve that is not in excess of 5% of expenditures paid out of current revenues during the preceding year.

### **What options are available to finance a long-term cash flow deficit?**

Current deficits that are projected to recur in future years may be financed on a longer-term basis, subject to an annual re-testing requirement:

1. On the first day of each fiscal year after the debt is issued, the Issuer must determine whether its "available amounts" of unrestricted funds are more than 5% of its operating expenditures during the prior fiscal year. This annual testing can be delayed up to five years depending on deficit projections.
2. Except as required below, within the first 90 days of that fiscal year, the Issuer must apply the available amounts in excess of the 5% amount (or if less, the available amount on the date of the required redemption or investment) to redeem or to invest in eligible tax-exempt bonds (as defined below). For this purpose, available amounts in a debt service fund for other bonds generally are not treated as available amounts.
3. With two exceptions, amounts invested in eligible tax-exempt bonds (instead of being used to redeem bonds) must be invested continuously in such tax-exempt bonds. The first exception allows amounts to be uninvested for no more than 30 days each fiscal period pending reinvestment in eligible tax-exempt bonds. The second exception allows Issuers to spend amounts previously invested in eligible tax-exempt bonds to cover expenses during future deficit periods, essentially to use the tax-exempt investments as a cash deficit line of credit, or to redeem the Issuer's tax-exempt bonds.
4. An eligible tax-exempt bond is (i) a tax-exempt, non-AMT bond; (ii) an interest in a tax-exempt, non-AMT money market fund; or (iii) a Demand Deposit State and Local Government Series (SLGS) investment.

### **What are the ways to finance working capital expenditures long term without worrying about cash flow deficits?**

Long-term tax-exempt bonds may be used to finance "extraordinary, nonrecurring items that are not customarily payable from current revenues." Said another way, an Issuer can use tax-exempt bonds to finance extraordinary expenses without regard to an actual cash flow deficit! The regulations use

casualty losses and extraordinary legal judgments in excess of reasonable insurance coverage as example of such expenditures. However, it seems reasonable to assume that working capital expenditures made to finance the fight against COVID-19 also will qualify.

If an Issuer maintains a reserve or has otherwise set aside funds for items of the same nature as the extraordinary expenditures (e.g., a self-insurance fund or a pandemic relief fund), those funds must be used before the bond proceeds may be allocated to the extraordinary expenditures.

One of the most common issues that arises with respect to these financings is how long the bonds may be outstanding before running into certain anti-abuse rules. However, the answer can't be worse than requiring the Issuer to comply with the requirements in the immediately preceding section, and therefore we believe that this type of working capital financing may be quite useful for Issuers to help finance their fight against COVID-19. The IRS has been asked to give guidance on this and other issues on an emergency basis in order to help Orrick bond counsel help their clients structure bonds issued under this provision. We will update this discussion after this guidance is received.

## OTHER ISSUES

### **What if Issuers expect to receive reimbursements from FEMA that will be used to pay the tax-exempt bonds?**

FEMA reimbursements may impact tax-exempt financings of both capital and working capital expenditures made to fight COVID-19. Generally, bonds may not be issued on a tax-exempt basis if the payment of such bonds is directly or indirectly guaranteed by the federal government.

Reimbursements to Issuers by FEMA, even if expect to be used to pay debt service, do not automatically cause a direct or indirect federal guarantee, but Issuers should let their Orrick bond and tax counsel know about the reimbursements early in the financing so that the bonds may be carefully structured to not run afoul of this prohibition.

### **May Issuers use tax-exempt bond proceeds to make grants to individuals and businesses?**

Yes, subject to state law constraints, Issuers may use tax-exempt bond proceeds to make grants to individuals and business if the grants further a governmental purpose for governmental purpose bonds or further the exempt purpose of the 501(c)(3) entity for qualified 501(c)(3) bonds. Well-designed grant programs can help Issuers prove compliance with a number of tax requirements and reduce record-keeping requirements for Issuers. For long-term bonds issued to finance grants for working capital purposes, the tax requirements described above for working capital financing generally apply. Orrick bond and tax counsel should be consulted to help design a grant program that will allow the Issuer to make grants with the least administrative burden possible.

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[1] To address any questions about the difference between a capital expenditure and a working capital expenditure, a capital expenditure is capitalized into the assets on the Issuer's balance sheet and a working capital expenditure is treated as an operating expense on the Issuer's income statement.