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Short-Term Financing Options for Illinois Units of Local Government: Ice Miller

The State of Illinois (the “State”) is likely to suffer material adverse consequences from the continued spread of COVID-19 and any economic downturn, which would affect the amount of State-shared revenues, such as Local Government Distributive Fund payments, appropriated to units of local government. The spread of the virus could also reduce sales tax, income tax, motor fuel tax, video gaming tax, and other collections dependent on local business activity, which is likely to be slower, and property tax collections could also be adversely affected. While Illinois governmental units are working to identify potential revenue impacts and aligning their budgets accordingly and, to the extent possible, developing reserve funds to assist with potential cash flow issues, units of local government may benefit from borrowing on a short-term basis.

Since local governments are generally labor-intensive, these working capital management measures might also include layoffs and furloughs that necessitate service reductions, payroll deferrals, or delays in vendor payments. Local governments, particularly those governments that do not carry large liquidity balances relative to operating needs, may explore extraordinary cash flow support measures in the near term. These may include financial market solutions such as lines of credit and tax/revenue anticipation notes or warrants issued either through public sales or private placements.

Can Illinois units of government borrow from the Federal Reserve Bank pursuant to the Federal Revenue Act? Under a new lending option called the Municipal Liquidity Facility authorized by the Federal Reserve Act, the City of Chicago and Cook County are authorized to form a special purpose vehicle (“SPV”), said SPV being authorized to then borrow from a Federal Reserve Bank. Due to population requirements, other units of local government are not authorized to borrow under this program. We are hopeful, however, that some further relief will come from future federal legislative action, because many issuers will have shortfalls and will need tools to deal with those shortfalls.

What tax collection delays have been instituted in Illinois to help taxpayers cope with the stress of COVID-19 and what is the expected impact to Illinois issuers? In order to help businesses cope with lost revenue and prevent layoffs, the State mandated through emergency legislation that certain local governments may delay the collection of some property tax payments. Certain units of local government in Illinois have adopted similar delay policies. Illinois has delayed the income tax filing deadline to align with the new federal filing date of July 15, 2020. Property taxes are typically the largest portion of total tax burdens imposed by Illinois local governments.

What financing tools are available for Illinois local governments to finance short-term obligations?

1. **Working Cash Fund Bonds** Traditionally, working cash fund bonds have been issued as short-term obligations where the proceeds are used to cover a governmental unit’s temporary cash flow or operating deficit. Short-term budgetary deficits also may arise from a mismatch in timing between the receipt of annual revenues (e.g., property taxes) and the incurrence of annual

expenditures of the governmental unit within a year. Counties, cities, villages, school districts, library districts, park districts, and community college districts are authorized to issue working cash fund bonds pursuant to statutory requirements.

2. **Tax Anticipation Warrants** Tax anticipation warrants ("TAWs") often are issued in anticipation of taxes levied, but not yet collected. TAWs may be issued in an amount not to exceed 85% of the issuer's last known equalized assessed valuation ("EAV") multiplied by the maximum permitted tax rate of the issuer for the particular fund against which the TAWs are issued. Counties, cities, villages, school districts, library districts, park districts, and community college districts are authorized to issue TAWs.
3. **Tax Anticipation Notes** Tax anticipation notes ("TANs") allow a governmental unit flexibility to balance its revenue collections from anticipated levies with anticipated expenditures. A governmental unit may be permitted to incur debt by issuing TANs in an amount not to exceed 85% of the issuer's last known EAV multiplied by the maximum permitted tax rate of the issuer for the particular fund against which the TANs are issued. Unlike TAWs, TANs are required to mature within two years and may not be issued if there is an unpaid note from any prior year. Although TANs are generally a means of balancing a governmental unit's operating expenses with revenue collections, TANs sometimes may be used as a "bridge" to fund a pending capital project while the governmental unit structures more permanent funding. Counties, cities, villages, school districts, library districts, park districts, and community college districts are authorized to issue TANs.
4. **Lines of Credit - Promissory Notes and Debt Certificates** Many banks offer lines of credit to Illinois units of local government. Typically, these are structured as promissory notes or debt certificates, normally in amounts greater than \$50,000 to be considered as "issued" for tax-exempt bond purposes. Notes and debt certificates are general obligations of the governmental unit, which are payable from all available resources including but not limited to ad valorem taxes, state aid, and the general fund of the governmental unit. Counties, cities, villages, school districts, library districts, park districts, and community college districts are authorized to issue these types of obligations.

What can be used as security for the short-term obligation? The Local Government Debt Reform Act (the "Debt Reform Act") allows flexibility in what may be pledged as a "revenue source" to the repayment of a debt obligation. "Revenue source" means a source of funds received or available to be received by a governmental unit and available for any one or more of its corporate purposes. Note that the source cannot be an enterprise revenue, for example revenue from a municipal water or sewer plant. The Debt Reform Act further authorizes a governmental unit to direct a county collector to deposit directly ("intercept") any amount of tax proceeds pledged to the payment of warrants into a designated escrow account established by the governmental unit. Utilizing an intercept provides the bondholders the security of having the pledged revenue source wired directly from the respective county collector to an escrow account to be used by the escrow agent for debt service on the obligation before any payment to the governmental unit.

As noted above, loans and debt certificates are general obligations of the governmental unit, which are payable from all available resources including but not limited to ad valorem taxes and state aid and the general fund of the governmental unit.

What is the difference between a debt certificate or promissory note and a TAN or TAW?

Generally, a TAW or TAN is payable solely from the tax levied but not yet collected for a specific fund or funds of the governmental unit and is generally outstanding for a short period of time; while a promissory note or debt certificate is a general obligation of the governmental unit, secured by all sources of the governmental unit and may be outstanding for more than one year.

When can short-term financings be financed as tax-exempt? Federal tax rules allow tax-exempt bonds or notes to be issued to finance working capital expenditures under certain circumstances. Working capital expenditures are expenditures that are not capital expenditures. For example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures. Costs of operations, debt service, or pension payments are working capital expenditures.

What are the primary tax law issues raised by the use of tax-exempt bond proceeds for working capital expenditures? The sizing of tax-exempt financings for working capital takes into account on a monthly basis the available amounts of revenue, the anticipated expenses, and a permitted working capital reserve that results in a cumulative cash flow deficit. The term is typically limited to 13 months, and certain rebate accounting can be avoided by sizing the obligations to cover a deficit that occurs within six months of the date of issuance of the obligations. The tax law also permits the financing of certain extraordinary working capital expenditures without regard to a cash flow deficit.

Federal tax rules also permit the issuance of longer-term working capital obligations, including extraordinary working capital borrowings. These rules require the issuer on the issue date to determine the first fiscal year following the 13-month period after date of issue in which it reasonably expects to have a surplus (the “first testing year”), which must be within five years of the date of issuance; determine the amount of surplus at the beginning of each testing year; and redeem bonds and/or purchase eligible tax-exempt bonds up to the amount of the outstanding working capital bonds.

What changes can be made to existing tax-exempt bonds to assist Illinois issuers in dealing with budget shortfalls during COVID-19? Any change to payment terms of a bond will require bondholder consent. Issuers may find that it is more difficult to get such consent for public bond issues than it is for private bond issues or bank-purchased bond issues. Some issuers are asking bondholders for accommodations to existing bond documents because of the COVID-19 crisis. Such changes could result in loss of tax-exempt status, so it is best to consult bond counsel first. Most documents will require an opinion of bond counsel, although that could be waived. The deferral of one or more scheduled payments on a bond (either principal or interest) within a safe-harbor period does not cause a reissuance resulting in loss of the bond’s tax-exempt status if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50% of the original term of the instrument.

A bondholder’s temporary forbearance to stay collection or waive default rights for a period of up to two years, plus any additional period during which parties conduct good faith workout negotiations or a bankruptcy case is pending, does not cause a reissuance resulting in loss of the bond’s tax exempt status.

Changes to a bond’s interest rate, obligor, or security always need to be analyzed, although the rules are different if such changes are permitted by the original bond documents. Some private placement deals contain formulas in the original bond documents which address the possibility of changes to the original structure.

[This chart](#) is intended to show the various options to finance working capital and basic requirements thereof:

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