# Client Alert

**April 2020**

## Tax-Exempt Working Capital Financings

**Introduction**

Due to existing volatility in financial markets and uncertainty regarding ordinary sources of revenue, governmental entities and 501(c)(3) organizations are increasingly considering options to finance resulting working capital deficits. This memorandum describes how qualifying borrowers (defined below) can finance working capital expenditures with proceeds of tax-exempt debt issuances.

**Background**

Governmental entities and 501(c)(3) organizations ("qualifying borrowers") often experience timing discrepancies between when they collect revenues and incur expenses from their operations, similar to for-profit organizations. These timing discrepancies create temporary deficits that frequently require short-term liquidity financing. In addition, qualifying borrowers sometimes experience longer-term structural operating deficits that create a need for similar interim financing, but on a longer-term basis.

The federal tax law permits qualifying borrowers to finance working capital expenditures from proceeds of tax-exempt debt issuances if certain requirements are satisfied. These provisions allow qualifying borrowers to finance working capital expenditures on a short-term basis (thirteen months or less), or longer terms if additional requirements described below are satisfied.

**Federal Tax Rules for Working Capital Expenditures**

Under Section 103 of the Internal Revenue Code ("Code"), gross income does not include interest on a state or local bond, provided that (a) the bond is not part of an issue that consists of arbitrage bonds, (b) the bond is not part of an issue of private activity bonds, other than certain qualified private activity bonds, and (c) certain additional requirements are satisfied. The primary rules relating to working capital financings are the arbitrage rules. The arbitrage rules govern the sizing, term, investment yield limitations, and accounting for proceeds of working capital borrowings.

*Sizing Working Capital Financings*. The size of a working capital financing is primarily a function of how qualifying borrowers are required to account for working capital expenditures. The federal tax rules generally require qualifying borrowers to account for expenditures of proceeds to finance working capital expenditures using a restrictive accounting method known as "proceeds-spent-last" ("PSL"). Under the PSL method of accounting, proceeds of working capital issues are allocated to expenditures only to the extent that those proceeds exceed a qualifying borrower's other "available amounts." Available amounts are any amounts (other than proceeds of an issue) available to a qualifying borrower or a related party to finance working capital expenditures without legislative or judicial action and without a legislative, judicial, or contractual requirement that such amounts be reimbursed. As an example, assume that an issuer has $2,000,000, $1,000,000 of which is held in a capital reserve fund that cannot be invaded absent approval by its governing body, and, even if the governing body approves the use of those funds for working capital expenditures, the issuer's charter requires that any funds used for those expenditures be reimbursed. The remaining $1,000,000 may be used for working capital expenditures without restriction. In this instance, the federal tax rules require that the unrestricted $1,000,000 be treated as spent for

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working capital expenditures before proceeds of a working capital financing. A qualifying borrower may generally treat a reasonable working capital reserve, not in excess of 5 percent of actual working capital expenditures for the prior fiscal year, as unavailable.

Once a qualifying borrower has determined its available amounts, then the qualifying borrower's expected cash flows are used to determine the maximum permitted size of the financing. The cash flows used for sizing purposes consist of actual, expected revenues and available amounts and actual, expected, cash outlays for working capital. Taking into account a qualifying borrower's available amounts and cash flows provides a determination of the qualifying borrowers' expected cumulative cash flow deficit over the period at issue (typically twelve months), and is the starting point for sizing the issue.

*Term and Temporary Period*. Working capital financings generally are subject to a rule that limits their term to no longer than thirteen months. Frequently, qualifying borrowers structure their working capital financings to mature within twelve months of the issue date. As long as the qualifying borrower reasonably expects that the proceeds of the issue will be spent for federal tax purposes within thirteen months of the issue date, the proceeds that remain unspent may be invested without regard to investment yield limitation during the thirteen month temporary period, but may be subject to arbitrage rebate if not spent (for federal tax purposes) within six months of the issue date (as described below).

*Exception to Arbitrage Rebate*. Generally, proceeds of tax-exempt bonds are subject to arbitrage rebate, which requires an issuer to pay the value of investment earnings that exceed the yield on the issue to the Internal Revenue Service. With respect to working capital financings, qualifying borrowers frequently use a rebate exception safe harbor, which requires sizing the issue so that (a) the qualifying borrower's cumulative cash flow deficit occurs within six months of the issue date, and (b) the amount of the cumulative cash flow deficit exceeds 90 percent of the proceeds of the working capital issue. Alternatively, a six-month exception to rebate may be available if all of the proceeds of the issue (including investment earnings) are actually treated as spent on working capital expenditures within six months of the issue date of the issue. Smaller qualifying governmental entities may qualify for an exception to the rebate requirement if the total amount of tax-exempt bonds issued by the entity in the calendar year in which the working capital issue is issued do not exceed $5 million.

*Long-Term Working Capital Financings*. Limited but significant ability is available for qualifying borrowers to finance deficits that require terms longer than thirteen months. In addition to the cash flow deficit determinations described above, the federal tax rules governing long-term working capital financings require the qualifying borrower to make determinations of available amounts beginning on the issue date and continuing annually until maturity. Available amounts existing as of those testing dates are required to be used to redeem outstanding bonds of the issue or invested in tax-exempt bond investments the interest on which is not subject to the alternative minimum tax.

*Volume Limit for 501(c)(3) Borrowers*. The Code prohibits qualified 501(c)(3) organizations (other than qualifying hospital organizations) from having more than $150 million of bonds outstanding if those issues were issued to finance (or refinance) expenditures incurred on or before August 5, 1997, or if less than 95% of the proceeds of those issues were used to finance capital expenditures incurred after August 5, 1997. Accordingly, working capital financings will be subject to this overall volume limitation for most 501(c)(3) organization borrowers.

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**Contacts**


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|---|---|---|---|
| **Atlanta** | **Douglass P. Selby**<br>dselby@HuntonAK.com | **Houston (cont.)** | **Ryan M. Bledsaw**<br>rbledsaw@HuntonAK.com |
| | **Caryl Greenberg Smith**<br>carylsmith@HuntonAK.com | | **Audra L. Herrera**<br>aherrera@HuntonAK.com |
| | **Yeshake “Isaac” Yilma**<br>iyilma@HuntonAK.com | | **Samantha Gilley Rachlin**<br>samantharachlin@HuntonAK.com |
| | **Benjamin Vernon**<br>bvernon@HuntonAK.com | **Richmond** | **Christopher G. Kulp**<br>ckulp@HuntonAK.com |
| **Austin** | **Darren C. McHugh**<br>dmchugh@HuntonAK.com | | **Brendan M. Staley**<br>bstaley@HuntonAK.com |
| **Charlotte** | **William H. McBride**<br>wmcbride@HuntonAK.com | | **Martha A. Warthen**<br>mwarthen@HuntonAK.com |
| **Houston** | **Thomas A. Sage**<br>tomsage@HuntonAK.com | **Washington, DC** | **Andrew R. Kintzinger**<br>akintzinger@HuntonAK.com |
| | **Clayton T. Holland**<br>clayholland@HuntonAK.com | | |


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