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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON TAX EXEMPT WORKING CAPITAL FINANCING

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Principal responsibility for preparing these Comments was exercised by Charles C. Cardall and Larry D. Sobel of the Committee on Tax-exempt Financing. Substantive contributions were made by Kimberly C. Betterton, Sarah A. Breitmeyer, David J. Cholst, Mark O. Norell, Victoria N. Ozimek, Lorraine M. Tyson and David A. Walton. The Comments were reviewed by Jeremy A. Spector, Chair of the Committee, Clifford M. Gerber of the Section's Committee on Government Submissions and by _______________, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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EXECUTIVE SUMMARY

Tax-exempt bonds are issued frequently to fund working capital expenditures. The majority of these transactions utilize short-term obligations. However, recent economic circumstances have placed significant budgetary pressures on States and local governments, necessitating the issuance of long-term working capital bonds. The current federal tax rules relating to working capital financings in general, and longer-term working capital financings in particular, are overly complex and difficult to apply. This report sets forth an analysis of the existing law and suggests various changes to the existing Treasury Regulations to simplify and clarify the rules relating to tax-exempt working capital financings. An appendix is attached that shows proposed changes to existing regulatory language.

INTRODUCTION

The arbitrage regulations promulgated under Section 148 of the Internal Revenue Code of 1986 (the "Code")[1] essentially divide the requirements for tax-exempt working capital financings into two distinct sets of rules. The first set relates to *when* tax-exempt bond proceeds are treated as spent on working capital expenditures. The second set of rules relates to *limitations on the maturity* of tax-exempt bonds issued to finance working capital expenditures.

Working Capital Financing Concepts. States and local governmental units have issued tax-exempt bonds to fund working capital expenditures in a variety of circumstances. Historically, working capital bonds or notes have been issued as short-term obligations (typically with maturities of less than 13 months) where the proceeds are used to cover an issuer's temporary cash flow, or operating, deficit. This arises most often due to a timing mismatch between annual revenues and annual expenditures of the issuer within a year. These short-term working capital obligations, often referred to as TRANS (tax and revenue anticipation notes), have short maturities and in some jurisdictions must be repaid using revenues from the same fiscal year.

Longer-term tax-exempt bonds issued for working capital have become more common in recent years as governmental entities have run into financial difficulties largely stemming from the recent economic recession. These difficulties have caused a number of governmental entities to issue longer-term bonds to cover so-called "structural deficits" (e.g., deficits other than a mismatch of the timing of receipts and disbursements within a year). Often, these long-term bonds are secured and payable from a specified revenue source. For example, a number of States and local governmental units have issued bonds secured and payable from tobacco settlement revenues paid to them which were a result of lawsuits against the tobacco companies. Other types of long-term bonds for working capital have included bonds to fund unemployment compensation or workers' compensation payments and bonds to finance losses from hurricane catastrophes.

Expenditure of Proceeds. As described in the arbitrage regulations, there are essentially three allowable categories of working capital expenditures that can be financed on a tax-exempt

[1] References to a "section" are to a section of the Code, unless otherwise indicated, and references to the "Regulations" are to the Treasury Regulations promulgated there under.

basis: (1) de-minimis working capital expenditures (e.g., small amounts of working capital expenditures tacked onto a larger capital project financing), (2) extraordinary working capital expenditures (e.g., large, non-recurring working capital payments such as the payment of a legal judgment) and (3) restricted working capital expenditures (e.g., deficit financings such as TRANs or "Long-Term Deficit Bonds"). As a technical matter, the tax-exempt financing of grants for working capital purposes is a fourth category of working capital expenditures. While some of the issues discussed herein apply to working capital grants, this paper does not focus on grant financing are beyond the scope of this paper.[2]

De-Minimis Working Capital Expenditures

To the extent the working capital expenditures to be financed are de-minimis, proceeds of tax-exempt bonds are treated as spent on or allocated to those expenditures as if those expenditures were for a capital project, i.e., the "proceeds-spent-last" rule, discussed below, does not apply.

Regulations Section 1.148-6(d)(3)(ii)(A) sets forth the list of expenditures that are considered de-minimis. Commonly used items on the list are costs of issuance of bonds, interest payments on a bond issue for up to three years, and using up to 5% of the proceeds of an issue to pay for working capital expenditures that are directly related to the capital project financed by that issue.[3] For example, in a new money bond issue that will finance construction of a new medical center, up to 5% of the proceeds of the bond issue may be used to finance initial operating costs at that medical center.

Extraordinary Working Capital Expenditures

To the extent the working capital expenditures to be financed are extraordinary and non-recurring, proceeds of tax-exempt bonds are treated as spent on or allocated to those expenditures as if those expenditures were for a capital project, i.e., the "proceeds-spent-last" rule, discussed below, does not apply, at least not to original proceeds of the issue.[4]

Regulations Section 1.148-6(d)(3)(ii)(B) describes the type of expenditure that is considered extraordinary. For an expenditure to be considered extraordinary, it must be a nonrecurring payment that is not normally paid from current revenues and for which insurance and reserves are not maintained. For example, some issuers have issued so-called judgment obligation bonds to pay for the costs of litigation, settlements or judgments. The Regulations also suggest that certain casualty losses can qualify.

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[2] The Section previously submitted comments on Bond Financed Grants, dated January 5, 2011. Those comments included a discussion of the tax limitations relating to grants for working capital and are available at: http://www.abanet.org/tax/pubpolicy/__________________.pdf.

[3] Note that the one item used in virtually every bond issue in the Regulations Section 1.148-6(d)(3)(ii)(A) list is costs of issuance, but costs of issuance for a long-term issue of bonds are capital expenditures. See Regulations under IRC Section 263.

[4] However, there is uncertainty in applying the overburdening concepts (discussed later) to these types of financings. Specifically, how long may an issue which finances extraordinary working capital expenditures remain outstanding without creating replacement proceeds.

Restricted Working Capital Expenditures – "Proceeds-Spent-Last"

The third category, restricted working capital expenditures, is the category that relates to using the proceeds of tax-exempt bonds to pay for non-capital expenses (e.g., operating expenses), other than those described above. Regulations Section 1.148-6(d)(3)(i) sets forth the basic requirement for this type of expenditure, known as the "proceeds-spent-last" method of allocating bond proceeds. Tax-exempt bond proceeds can only be allocated to a working capital expenditure that is not de-minimis, extraordinary or a grant to the extent the issuer has a cash deficit of "available amounts" at the time of the expenditure.

Pursuant to this rule, bond proceeds deposited to an issuer's general fund to finance working capital expenditures are spent to the extent the working capital expenditures to be financed with the proceeds exceed "available amounts." That is to say, in the absence of cash in the general fund at the time of the expenditure, proceeds deposited therein to finance working capital costs may be treated as spent for federal income tax purposes when there is an outlay of cash. The calculation of the cash balance reflects the issuer's "unrestricted" fund balances, which include revenues received in the general fund, or revenues received or deposited into other unrestricted funds, less expenditures that are payable from these same revenues. For these purposes, "available amounts" include all amounts in any funds or accounts maintained by or on behalf of the issuer that can be used by the issuer to pay working capital expenditures of the type financed without legislative or judicial action and without a bona fide legislative, judicial or contractual requirement that such amounts be reimbursed.

In determining whether a cash deficit exists, the issuer can treat available amounts on hand that constitute a "reasonable working capital reserve" as unavailable. A reserve that is equal to 5% of the issuer's expenditures for the most recent fiscal year is treated as a reasonable working capital reserve and therefore unavailable. The wording of the Regulations makes clear that a larger reserve may be possible in certain circumstances. A separate provision prevents an issuer from funding its reserve with tax-exempt bond proceeds. So long as the reserve amount used to size the bond or note issue does not exceed the issuer's historical working capital reserve,[5] the bonds or notes are not considered to fund the reserve. Thus, the reasonable working capital reserve is generally the lesser of (i) the historical working capital reserve or (ii) 5% of the issuer's expenditures for the most recent fiscal year. The historical working capital reserve may be computed using the average of the beginning or ending monthly balances of the amount maintained as a reserve (not including unspent bond proceeds) during a one-year period preceding the closing date for the bonds.[6]

One concern with the current Regulations' historical working capital reserve calculation is that it tends to penalize issuers that are in the worst financial position. Those issuers generally

[5] If an issuer qualifies for the small issuer rebate exemption, it can treat the full 5% of the prior fiscal year expenditures as a reasonable working capital reserve, even if the issuer's historical reserve is less.

[6] Current regulations provide flexibility in the choice of the period over which the average historical reserve may be computed. Multiple year periods may be used in place of a one-year period. If a one year period is used it need not match to a calendar year, a bond year or a fiscal year.

have not been able to accumulate or maintain reserves or available amounts fund balances because they have been the most cash poor. As such, those issuers are not able to utilize the working capital reserve provisions. Issuers that have been able to maintain large cash balances, up to or exceeding the 5% limit, have benefitted the most from the application of this rule.

Another rule relating to the expenditure of proceeds for restricted working capital purposes that requires discussion is the special expenditure exception to the arbitrage rebate requirement for "tax and revenue anticipation bonds" under Section 148(f)(4)(B)(iii). While proceeds are deemed spent on the date the issuer's cash deficit (computed without regard to any reserves) equals 90% of the proceeds of the issue (but only if such deficit occurs within the first six months after the issue date), no definition is provided for the term "tax and revenue anticipation bond."

Maturity Limitations - Other Replacement Proceeds. The arbitrage regulations establish and implement a federal policy against tax-exempt bonds being left outstanding longer than is necessary to achieve the governmental purpose of the financing. As described below, short-term working capital financings (typically, notes outstanding for no longer than 13 months) are deemed not to be outstanding longer then necessary. If the structure of an issue allows bonds to be outstanding longer than necessary, the bonds are deemed to "overburden the market" for tax-exempt securities. See Regulations Section 1.148-10(a)(4). Bonds that overburden the market are subject to special limitations. See Regulations Section 1.148-10(b). In addition to these general overburdening provisions, there are specific overburdening rules relating to "other replacement proceeds" in Regulations Section 1.148-1(c)(4). The relationship between the general overburdening provisions and the other replacement proceeds provisions is complicated, circular and in need of refinement and repair.

During the period that an issue remains outstanding longer than necessary, Regulations Section 1.148-1(c)(4)(i)(A)(2) contemplates that other replacement proceeds arise as of the first day of a fiscal year to the extent of any available amounts. Thus, other replacement proceeds include the issuer's unrestricted cash balances as of the first day of a fiscal year to the extent such amounts exceed the issuer's reasonable working capital reserve.[7] The circular element is that other replacement proceeds only arise in the first place if an issue overburdens the tax-exempt market. However, if bonds are structured so that the amounts that would be other replacement proceeds are used in a manner that offsets the potential overburdening, those amounts technically never become other replacement proceeds with the result that there will be no overburdening. This concept is exemplified in Private Letter Ruling 9424043, otherwise known as the "School District Ruling."

In the School District Ruling, avoiding overburdening and other replacement proceeds was accomplished based on a combination of general budgetary expectations of the issuer and an obligation to redeem bonds with amounts that otherwise would have been other replacement proceeds. The ruling involved a school district (the "District") that had been taken over by the State in which it was located (the "State") due to its financial distress. Prior to being taken over by the State, the District had issued debt to finance its working capital needs (the "Working

[7] In calculating other replacement proceeds the Regulations appear to allow for a 5% reserve amount to be treated as unavailable irrespective of the amount of an Issuer's historic working capital reserve.

Capital Debt"). At the time the ruling was requested, the District was engaged in bankruptcy litigation and had defaulted on payments on the Working Capital Debt. As part of a proposed settlement in the bankruptcy action, the District proposed to refinance and extend the maturity of the Working Capital Debt.

Due to the District's financial difficulties, State law required that a detailed study and plan of the District's finances for the next 5 years (the "5-Year Plan") be prepared. This 5-Year Plan was prepared by independent experts and projected available cash flows for the next 5 years. The District also had prepared longer-term projections beyond the 5-Year Plan (the "Long-term Projections"). The District structured the refunding of the Working Capital Debt with debt service and a 30-year term taking into account the projected cash flows under the 5-Year Plan and the Long-term Projections. The projected cash flows also included maintenance of a State mandated general fund reserve in excess of the 5% reasonable working capital reserve safe harbor amount. Based on these projections, after payment of debt service on the refunding bonds, the District did not expect to have excess moneys or available amounts during any year the refunding bonds would be outstanding.

The IRS agreed that the cash flow projections under the 5-Year Plan were reliable due to the detail of the data taken into account and the relatively short period of the projections. However, the IRS did not believe the cash flow projections in the Long-term Projections were as reliable. Therefore, the ruling required that "surplus available revenues" be determined beginning after the fifth anniversary of the issue date of the refunding bonds and be used to redeem a portion of the refunding bonds within six months (or yield restricted). The surplus available revenues were to be measured as of the beginning of each fiscal year.

The criteria applied by the IRS in this ruling were designed to deal with the overburdening and other replacement proceeds issues. The IRS believed that if and when the District had surplus funds available, such funds should be used to redeem working capital bonds (or be subject to yield restriction) to avoid overburdening the market for tax-exempt bonds. Redeeming the working capital bonds was designed to avoid the overburdening by reducing the amount of tax-exempt debt at a time when the governmental purpose of the issue had been fulfilled, i.e., the District no longer had a need to continue to borrow for working capital purposes (or at least had a reduced need). The five year "grace" period before testing for other replacement proceeds was based on the IRS being convinced that the District had solid projections of cash shortfalls for at least that time period. To the extent the surplus available revenues were used to redeem bonds, no other replacement proceeds were ever created.

Managing Other Replacement Proceeds

While the School District Ruling provides one method of applying (and avoiding) the overburdening and other replacement proceeds limitations, there are other effective measures which can be taken to deal adequately with the overburdening concerns. For example, other replacement proceeds could be defined to exclude amounts that are: (i) actually used to purchase or redeem other working capital borrowings (including extraordinary working capital borrowings) of the Issuer within the correct time period, (ii) expected to be spent during the subsequent fiscal year (or perhaps during the first six months of the subsequent fiscal year) on working capital expenditures pursuant to the proceeds-spent-last rule, or (iii) invested in other

tax-exempt obligations the interest on which is not a specific preference item for purposes of the alternative minimum tax ("non-AMT bonds").[8] These actions "unburden" the tax-exempt market by the same amount that the other replacement proceeds would overburden the market.

Where amounts that would be other replacement proceeds are to be used to purchase or redeem outstanding working capital bonds or to purchase non-AMT bonds, there will necessarily be a time lag between the date as of which the amount of potential other replacement proceeds is calculated and the date by which those funds should be used for such purchases or redemptions. For example, if the amount of potential other replacement proceeds is to be calculated as of the first day of a fiscal year, the issuer's actual cash balance on that day usually is not known with certainty until several months later (i.e., the calculations cannot be performed by all issuers accurately in "real" time). The time lag may be accommodated by permitting an issuer some time to determine the amount that would be other replacement proceeds (e.g., 2-3 months) and another period to provide adequate notice to bondholders that their bonds are going to be redeemed early or an adequate period to obtain non-AMT bonds in the market, with the result being that a like amount of unburdening will take place within a reasonable period of time (e.g., six months).

Where the amount of potential other replacement proceeds are reduced by the amount of an issuer's projected available amounts cash flow deficit (e.g., the amount that could otherwise be funded with tax-exempt TRANs), most issuers prepare a projected cash flow analysis prior to the expected cash flow deficit date. Indeed, it is common in many jurisdictions for those projections to be done before the end of the prior fiscal year. In those cases, issuers use such cash flow deficit projections for purposes of determining the amount that would be other replacement proceeds; i.e., they reduce the amount of potential other replacement proceeds by the size of their upcoming projected cash flow deficit (which will, in turn, reduce the size of the permitted TRANs issue).

Use and Investment of Other Replacement Proceeds

In the Richmond School District Ruling, the IRS allowed the District to invest amounts that became other replacement proceeds at a rate not in excess of the yield on the bonds. This appears to have been an application of the overburdening rules in Regulations Section 1.148-10(b). However, these rules are difficult to apply to working capital financings, because the determination of whether other replacement proceeds exist will not be known at the time the bonds are issued. Moreover, application of these rules seems to depend on whether the issuer can prove that it reasonably expects to experience financial distress for the term of the bonds.

Under Section 1.148-10(b) (the "Overburdening Rules"), an issue that does, in fact, overburden the tax-exempt market is subject to special limitations, including (1) yield restriction to within one-thousandth of one percent of the bond yield (not subject to blending with other investments), (2) yield reduction payments and qualified administrative cost recovery do not apply, and (3) proceeds are not considered allocated to expenditures unless the proceeds-spent-last rule is satisfied (with no ability to treat an otherwise reasonable working capital reserve as

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[8] Note, by definition any other replacement proceeds, or amounts that would be treated as such absent other facts, will reduce the size of the issuer's subsequent annual TRANs borrowing.

unavailable). If an issue is reasonably expected to overburden the market at the time of issuance, the special yield restrictions apply to all gross proceeds of the issue. Where the market is overburdened as a result of an action or inaction after the issue date of the subject bonds, the special yield restrictions generally apply only to the portion of an issue that overburdens the market.

One of the most challenging problems presented by the Overburdening Rules is determining to which amounts it applies. Even if the issuer never expects any other replacement proceeds to arise, all other replacement proceeds could be subject to the Overburdening Rules, rather than the normal yield restrictions applicable to replacement proceeds. Further, because no reasonable working capital reserve is allowed under the Overburdening Rules, the issuer would be required to test twice for other replacement proceeds (once using the other replacement proceeds rules under Regulations 1.148-1(c)(4) and once using the Overburdening Rules). It is not clear how to determine the amount of other replacement proceeds that actually arise. Finally, many issuers may not have adequate projections of cash deficits for the life of an issue. In those cases, it may be that even the original proceeds of the issue are subject to the Overburdening Rules unless a structure is in place to avoid the creation of other replacement proceeds.[9]

Short-term Working Capital Obligations, e.g., TRANS

For short-term restricted working capital financings, the Regulations provide a maturity safe harbor of two years. Pursuant to Notice 2001-49 and Revenue Procedure 2002-31, this two-year maturity safe harbor *appears* to have been repealed and replaced with a maturity safe harbor of 13 months. As a result the TRANs of most issuers are structured to fit within this thirteen-month safe harbor.

The foregoing discussion represents a discussion of our interpretation of how the existing rules in the Code, Regulations and other authorities may be applied to tax-exempt working capital financings. Below is a discussion of various proposals for improving and simplifying the applicable Regulations.

PROPOSAL FOR SIZING OF A WORKING CAPITAL RESERVE

In determining whether a cash deficit exists, issuers can treat available amounts on hand that are not in excess of a reasonable working capital reserve as not being available. Regulations Section 1.148-6(d)(3)(iii)(B) (the "Reserve Regulation") sets forth the rules for what is treated as a "reasonable working capital reserve." It provides that "any working capital reserve is reasonable if it does not exceed five percent of the actual working capital expenditures of the issuer" in the prior fiscal year. The Reserve Regulation also allows an issuer to treat any expenditure paid out of current revenues during the preceding year as working capital expenditures for purposes of computing the five percent amount.

[9] Absent clarification as to the appropriate maturity limitations for extraordinary working capital bonds the same concerns exist and the same "relief" provisions should be applicable. There are situations where the appropriate maturity structure will be based on the facts and circumstances of the particular situation. In other cases it will not be clear, and the issues discussed herein should be applied equally to both long-term working capital bonds and extraordinary working capital bonds.

The five percent amount is a safe harbor and is not an absolute maximum (although the discussion below regarding Regulations Section 1.148(c)(4)(ii) indicates that issuers are not automatically entitled to the 5% reserve). It is not clear how, absent a ruling, an issuer could establish that a working capital reserve that exceeds the five percent safe harbor is reasonable. However, the IRS has concluded in certain circumstances that a reserve in excess of the five percent safe harbor is reasonable, e.g., where a larger reserve is mandated by state law and such reserve requirement existed before the proposed financing (see, *e.g.*, PLR 200446006). Also, the Reserve Regulation is somewhat ambiguous as to the base against which the five percent limit is applied (for example, may capital expenditures paid using current revenues be included?; may federal funds provided for a specified purpose be included?). Technical Advice Memorandum 200413012 clarified that the base for the five percent limit includes all working capital expenditures of the issuer in the prior fiscal year, including those working capital expenditures paid from the issuer's restricted funds that otherwise were not treated by the issuer as available.

Regulations Section 1.148(c)(4)(ii) (the "Directly or Indirectly Financed Regulation") provides generally that replacement proceeds arise to the extent a working capital reserve is, directly or indirectly, financed with the proceeds of the issue (regardless of the expenditure of the proceeds of the issue). The Directly or Indirectly Financed Regulation makes it critical to determine whether an issuer qualifies as having maintained a working capital reserve without regard to the issue itself. The Directly or Indirectly Financed Regulation allows an issuer to determine the amount of the working capital reserve it has maintained by reference to the issuer's average balance during a period of at least one year. It specifically provides that amounts in a working capital reserve can be computed using the average of the beginning or ending monthly balances of the amount maintained as a reserve (not including unspent proceeds of the bonds) during the one-year period preceding the closing date for the bonds (the "Average Monthly Balance Rule"). Therefore, it is common for the reasonable working capital reserve to be computed by using the Average Monthly Balance Rule.

There are policy and technical problems associated with the Average Monthly Balance Rule and the concept of directly or indirectly financing a working capital reserve. As noted above, the Average Monthly Balance Rule rewards issuers with larger average cash balances and penalizes issuers with poorer historic cash positions. Thus, those issuers most in need of "assistance" are treated less favorably than those that have historically had stronger financial resources. Further, questions have been raised about how deficit cash periods (e.g., negative balances) are to be taken into account for purposes of determining the monthly balances (do those months count as having a $0 cash balance or a negative cash balance?). Finally, many issuers have statutorily imposed reserve requirements, and it is not clear how those required reserves may be taken into account in the analysis.

We propose that Regulations Section 1.148-1(c)(4)(ii) be deleted in its entirety. We also propose that Regulations Section 1.148-6(d)(3)(iii)(B) be clarified to effectively repeal Technical Advice Memorandum 200413012 (or, this TAM should simply be withdrawn). Thus, the Regulations would specifically define the amount of a reasonable working capital reserve as being at least five percent of the actual available amount expenditures of the issuer in the prior fiscal year. This approach is simple, logically consistent, treats all issuers in the same way and provides clear guidance to both issuers and bond counsel when sizing a reasonable working

capital reserve. In addition, by reference to the minimum size of a reasonable working capital reserve, the resulting interpretation is that there may be situations where a larger working capital reserve is reasonable (e.g., when mandated by state law and such requirement is unrelated to the financing). (See, Proposed Regulatory Changes, Section A, Sizing Reasonable Working Capital Reserves.)

PROPOSALS FOR OTHER REPLACEMENT PROCEEDS

Formalizing a Post- Issuance Testing Procedure for "Other Replacement Proceeds"

In subsequent sections of these Comments, we propose certain grace period safe harbors designed to allow some issuers to avoid overburdening and other replacement proceeds testing entirely. Even if that proposal is adopted, all working capital transactions will not fit within the such safe harbors. Thus, some issuers of Long-Term Deficit Bonds[10] will be required to monitor available amounts to (i) avoid the creation of other replacement proceeds or (ii) manage the investment and expenditure of other replacement proceeds. Under current law, other replacement proceeds arise only if, under Regulations Section 1.148-10, the bonds remain outstanding longer than necessary to accomplish the governmental purpose of the issue. In many cases the governmental purpose of a bond issue is not just the elimination of an immediate cash flow deficit, but also the elimination of recurring (usually annual) deficits throughout the life of the bonds. As set forth above, the current Regulations support using periodic testing, in a manner similar to that required when TRANs are issued, to see if bonds are to remain outstanding longer than necessary. Bonds should not be considered outstanding longer than necessary if they are never outstanding in an amount that is greater than that which could be achieved with multiple issues of short-term bonds which themselves would not be considered outstanding longer than necessary. We propose specific rules to clarify the manner in which this periodic testing is to occur.

Our suggestion follows the concept of Code Section 147(b)(4), allowing a single bond issue to remain outstanding over a term that incorporates a number of shorter periods over which bonds could remain outstanding. Our proposal also incorporates the concepts of reasonable expectations, actual facts and remedial actions. First, the issuer must reasonably expect the bonds to meet the limits (i.e., that bonds are never outstanding in an amount that is greater than could have been achieved with multiple issues of short-term bonds which themselves would not be considered outstanding longer than necessary). Second, the issuer must have reasonable procedures in place to monitor whether the limits have in fact been met. Third, if the issuer discovers that it is over the limits, it must promptly take an appropriate remedial action. In essence, this means that the issuer will go through the same sizing methodology it would use for a tax-exempt TRAN to determine if there is a potential for other replacement proceeds. To the extent the issuer reasonably expects as of a testing date (the "Projection Date") it will have a traditional "available amounts" cash flow deficit that would be sufficient to justify a short-term issue, the bonds would not be outstanding longer than necessary and there would be no other replacement proceeds. To the extent the issuer does not reasonably expect, on the Projection Date, to have a traditional, available amounts cash flow deficit, the issuer would need to take a

[10] Note that the same issues may apply to long-term extraordinary working capital bonds.

remedial action related to the amount of funds equal to the lowest positive balance of available amounts projected on the Projection Date (the "Excess Amount").

Although the Regulations literally impose a requirement to test for other replacement proceeds on the first day of each fiscal year, that one-size-fits all approach seems arbitrary and subject to easy manipulation by issuers of available amount balances on that date. As a practical matter, most issuers experience cyclical deficits related to the calendar or fiscal year, and so will likely want to test every twelve months. In some jurisdictions, the most obvious testing date is at the start of the fiscal year. In other jurisdictions there is no connection between the timing of anticipated deficits and the start or finish of a fiscal year. Anticipated revenues from tax levies for a single levy year may span two fiscal years. It is therefore important that the Regulations not impose arbitrary testing dates. We recommend that the Projection Date be any date that the issuer might otherwise be able to issue a new tax-exempt TRAN.

Further, on each Projection Date, an issuer will need to make cash flow deficit projections similar to the projections used for tax-exempt TRAN issuance. The most accurate projections are made over relatively short periods. For example, if a particular issuer's cycle indicates that it expects large deficits at the end of May, it should be able to choose a Projection Date in March or April so that it will be able to make an accurate projection. While most issuers will choose the same date each year, there seems to be no reason why an issuer could not change its testing date as its revenue receipt dates change over time. Because a short-term working capital issue with a maturity of 13 months or less is never treated as outstanding longer than necessary (see Revenue Procedure 2002-31, 2002-1 CB 916), we recommend the time between consecutive Projection Dates should not be more than thirteen months, and that there must be a Projection Date during every fiscal year that the issue is outstanding.

Thus, no other replacement proceeds will arise if, during a given year, the issuer reasonably expects to have a traditional, available amounts cash flow deficit. Note that once the proceeds of the Long-Term Deficit Bonds have been spent, the existence of the Long-Term Deficit Bonds results in larger available amount balances equal to the amount of the Long-Term Deficit Bonds outstanding. If the issuer does not in fact expect a deficit, the issuer will need to take a remedial action with respect to the Excess Amount. The different remedies are discussed below and include investing the Excess Amount in non-AMT bonds or redeeming the Long-Term Deficit Bonds (or other working capital bonds of the issuer) with the Excess Amount within a certain time period.

Because it does take some time to accomplish these remedial actions, remediation cannot be required to take place on the Projection Date. Additionally, if the remedial action consists of bond redemption, typically at least thirty days is needed to provide redemption notice. To accommodate all issuers, actual redemption of bonds should not be required less than 90 days after the Projection Date. If the remedial action is the purchase of non-AMT bonds, again some amount of time is required. We suggest the same period of 90 days be permitted to make these investments. (See, Proposed Regulatory Changes, Section B.)

Remedial Action – Investing in Non-AMT Tax-Exempt Obligations

Investing the Excess Amount in non-AMT bonds in a manner similar to the requirement to invest net sale proceeds under the "hedge bond" rules in Section 149(g)(3)(B) is a practical method by which issuers should be able to rectify the potential overburdening of the tax-exempt bond market. Section 149(g)(3)(B) provides for the investment of net sale proceeds of an issue for the prevention of hedge bond treatment. The same requirements can be applied to the Excess Amount as the theory behind the two provisions is similar. Using this method of unburdening, the issuer will, within 90 days of the Projection Date invest at least 95% of the Excess Amount in non-AMT bonds. Such amounts will remain invested in non-AMT bonds until the earlier of (i) an actual deficit allowing Excess Amounts to be spent on a proceeds-spent-last basis or (ii) until 90 days after the next Projection Date. Excess Amounts also should be permitted to be used to pay for capital expenditures, which themselves would otherwise have been eligible for tax-exempt financing, subject to the non-AMT investment requirements until spent. The capital expenditure approach will also have the effect of reducing the amount of tax-exempt bonds in the market. As provided in Section 149(g)(3)(B), the issuer should be given a grace period of 30 days to reinvest maturing investments or interest receipts. Such grace period is a reasonable accommodation to address the difficulty in locating and purchasing non-AMT bonds. Additionally, to ease the burden, we believe that variable rate demand deposit SLGS should be treated as non-AMT bonds for this purpose as they are for other arbitrage purposes. Mutual funds that historically invest exclusively in non-AMT bonds should also be treated as non-AMT bonds. (See, Proposed Regulatory Changes, Section B.)

Although the annual testing mechanism may appear complex, the proposed regulatory change is quite simple. Under Treas. Reg. § 1.148-10, long-term bonds (at least for working capital or extraordinary working capital purposes) should not be treated outstanding for longer than necessary if such bonds are not to remain outstanding in an amount larger than the amount of short-term bonds that could have otherwise remained outstanding.

Budget Deficit Working Capital Bonds-Avoiding Periodic Testing

Introduction. As discussed previously, issuers incur budget deficits that may be financed with proceeds of bonds. Short-term working capital financings are most common when these deficits are simply caused by a mismatch of the timing of receipts and disbursements within a year, but with annual receipts equaling or exceeding annual expenditures (i.e., intra-year deficits).

Often, particularly in recent times, issuers find themselves with prolonged financial difficulties. In these situations, a single short-term financing will not resolve the financial deficit problem, and bonds are issued with maturities of two to twenty years or more. The deficits may begin slowly and subsequently evolve (gradually or quickly) into significant financial problems ("structural deficits"). Once deficits become structural, an issuer is faced with many challenges (e.g., decisions as to whether to raise revenues or reduce expenses or both) with tax-exempt financing considerations normally being secondary to the broader challenges facing such issuer. It may take several years to eradicate the structural problem and bring revenues and expenses into balance. The deficit(s) may be financed with one or more long-term borrowings or through a series of "rolling" annual short-term borrowings with at least one short-term borrowing

outstanding at all times. Long-term borrowings are the appropriate "fix" for such deficits for a number of reasons. A single long-term issue may have lower issuance costs associated with it than a series of short-term deals. A long-term issue allows a local government to fix the rate of interest it must pay over an extended period of time and plan for a solution. The issuance of long-term bonds often is accompanied by the creation or pledge of a new and separate revenue stream (*e.g.,* a new real estate tax, a new or increased sales tax, or the pledge of tobacco settlement revenues) dedicated to the payment of such a bond issue. Thus, the issuance of long-term bonds may permanently solve the deficit situation while the bonds are amortized over a period that is reasonable for local taxpayers.

In an effort to simplify the tax rules relating to the issuance of bonds in these circumstances, provisions addressing a category of "budget deficit working capital bonds" are proposed. The proposal primarily addresses issues related to other replacement proceeds and the overburdening rules which relate to bonds remaining outstanding longer than necessary. Basically, if a working capital bond issue meets the duration and amount limitations, an issuer would not be required to do any testing for other replacement proceeds or to determine whether the bonds constitute an overburdening. The proposal builds on concepts set forth in the Richmond School District Ruling in that it creates safe harbors that allow issuers to avoid periodic testing for these types of compliance issues.

The proposal is analogous in many, but not all, respects to the adoption of rules allowing an 18-month rebate exception. Section 148 of the Code provides for the 6-month rebate exception and the 2-year rebate exception. Seeing a void in the Regulations, the Treasury added, by regulations, an 18-month rebate exception. The provisions for budget deficit working capital bonds similarly would fill a void by providing clear and simple rules for issuers needing to incur long-term debt to finance budget deficits. Such rules are intended to enhance orderly and efficient tax administration.

The proposed rules address both one-time occurrences and multi-year structural budget deficits. Importantly, the provisions provide clear and simple rules for issuers to follow during times when they are facing challenging fiscal problems. The provisions provide issuers a mechanism to manage, address and resolve difficult fiscal problems.[11] (See, Proposed Regulatory Changes, Section C.)

Description of Budget Deficit Working Capital Bonds

To utilize the provisions for budget deficit working capital bonds, issuers must establish an actual or expected budget deficit. A budget deficit is defined as the amount by which annual expenses exceed annual revenues. The amount of the budget deficit is to be determined on a cash basis (similar to the methods used in computing projected shortfalls for TRANs).

Specific durations for the budget deficit working capital bonds are proposed based on the size of the deficit. The larger the deficit, the longer the period for which the bonds may be outstanding, thereby allowing issuers longer recovery periods as the budget problems are more severe. These limitations would be provided as an alternative to a long-term bond issue

[11] The proposed safe harbor provisions should apply equally to extraordinary working capital bonds.

incorporating a procedure for annual testing and remediation of any overburdening. For budget deficits: not exceeding [3] percent of annual revenues, bonds may be outstanding no longer than [5] years without a requirement for annual testing and possible remediation; more than [3] percent of annual revenues, bonds may be outstanding up to [10] years; more than [7] percent of annual revenues, bonds may be outstanding no longer than [15] years; and more than [10] percent of annual revenues, bonds may be outstanding up to [20] years. In each case, the issuer should be given an option of issuing bonds longer than these limits if the Issuer establishes an adequate annual testing and remediation mechanism.

The approach is based on provisions in the Local Finance Law (the "LFL") for the State of New York relating to financing judgments and tax refunds for appeals with respect to municipal property taxes. The LFL specifically provides for a general 5-year general debt maturity limitation for judgments, a 10-year debt maturity limitation for judgments in an amount greater than one percent of the average assessed valuation of the issuer, and a 15-year debt maturity limitation for judgments in an amount greater than two percent of the average assessed valuation of the issuer.

The LFL further provides for a 10-year debt maturity limitation for tax refunds in an amount greater than one percent and less than three percent of a municipality's real property tax levy, a 15-year debt maturity limitation for tax refunds in an amount greater than three percent and less than five percent of a municipality's real property tax levy, and a 20-year debt maturity limitation for tax refunds in an amount greater than five percent of a municipality's real property tax levy. See New York Local Finance Law Section 11.00 33 and 33a: http://public.leginfo.state.ny.us/LAWSSEAF.cgi?QUERYTYPE=LAWS+&QUERYDATA=$$LFN11.00$$@TXLFN011.00+&LIST=LAW+&BROWSER=EXPLORER+&TOKEN=04165759+&TARGET=VIEW

Because the provisions are intended as a safe harbor, a limitation of 30 percent of the actual working capital expenditures of the issuer in the prior fiscal year is proposed as an overall limit on the aggregate principal amount of budget deficit working capital bonds that may be outstanding at any one time. Of course, the safe harbor could be adopted with a higher threshold or without any amount limitation as issuers will typically be motivated to resolve budget deficits as quickly as reasonably possible absent tax considerations.

The proposed provisions are intended as a safe harbor and are not intended to be the exclusive means by which issuers can access the long-term credit markets on a tax-exempt basis to finance deficits.

PROPOSALS FOR ALLOCATION AND ACCOUNTING CONCEPTS

Deemed Expenditure of Proceeds

As described above, the arbitrage regulations require that the proceeds of a restricted working capital financing can only be spent by using the proceeds-spent-last method. Also as described above, Section 148(f)(4)(B)(iii) sets forth a special "deemed" expenditure rule such

that restricted working capital proceeds are deemed to be spent at the time a deficit reaches a certain level. The rule in the Code preceded the rule in the Regulations, but there appears to be little practical difference between deeming that proceeds are spent to finance a deficit and only allowing proceeds to be spent when there are no other available amounts. The Regulations should be clarified to make this explicit.

Consider what actually happens as an accounting matter at the time a cash deficit occurs in an issuer's unrestricted funds. It is not possible to maintain a negative cash balance. Instead, an expenditure is often paid from other funds by way of a so-called "inter-fund transfer," which is a transfer from the issuer's restricted funds to the issuer's unrestricted funds. If the proceeds of a working capital borrowing are available to cover the deficit expenditure, and the proceeds are not used directly to pay the expenditure, then the proceeds are used to repay the inter-fund transfer. In either case, the proceeds must ultimately be allocated to the working capital expenditure and not to the restricted fund. The point here is that the proceeds-spent-last accounting method is often effectively a deemed expenditure rule, i.e., in those cases where proceeds are used to repay an inter-fund transfer. In fact, this result is made explicit by the second and third sentences of Regulations Section 1.148-6(d)(5). To avoid the confusion caused by comparing and contrasting these three provisions, this conclusion should be explicitly set forth in a single place in the Regulations. (See, Proposed Regulatory Changes, Section D.)

Available Amounts and Unspent Proceeds

Confusion exists as to the treatment of proceeds of one issue of working capital obligations as being available amounts for purposes of a second issue of working capital obligations. The definition in Regulations Section 1.148-6(d)(3)(iii)(A) contemplates that the proceeds of any debt (including working capital obligations) are not available amounts. However, the IRS has ruled that for purposes of spending the proceeds of a tax-exempt working capital issue, the proceeds of a second, taxable issue of working capital obligations are available amounts. See PLR 200446006. This leads to absurd results.

For entirely non-arbitrage motivated practical reasons, an issuer may issue tax-exempt and taxable working capital obligations in order to manage its budget and cash flow uncertainty. The tax-exempt issue could be sized conservatively, assuming an optimistic budget result, and the taxable issue can then be used to cover the larger deficit resulting from a less favorable budgetary solution. Alternatively, the same issuer could issue the conservatively sized tax-exempt issue and wait until it is clear that a larger than optimistically anticipated budget will occur. At that time, the issuer could issue a second tax-exempt issue. In either case, the expenditure rules cannot work unless the issuer is able to spend the proceeds of one issue before the proceeds of the second issue.

We propose that the Regulations be amended to make it clear that proceeds of an issue are not treated as available amounts for purposes of applying the proceeds spent last rule to that issue, or to any other issue of obligations to be used for working capital expenditures. This could be accomplished with a simple change to Regulations Section 1.148-6(d)(3)(iii)(A) so that the second sentence refers to proceeds of "an" issue rather than just proceeds of "the" issue. (See, Proposed Regulatory Changes, Section D.)

PROPOSAL FOR SHORT-TERM SAFE HARBOR

Currently, there are no definitions of "short-term" and "long-term" in the context of working capital debt. Short-term working capital financings refer to those financings used by issuers to address timing mismatches of revenues and expenditures during a single fiscal year. Such financings are often referred to as TRANs. In contrast, long-term working capital financings are usually issued as a result of a deficit created by continued economic distress experienced by an issuer. In certain cases, however, delineation between the two types of working capital financings based on a "purpose based" definition becomes difficult to apply. For example, during downturns in the economy, where tax revenues often decline and the need for government services increases, an issuer may need a longer adjustment period to account for mismatches. Allowing a TRAN maturity that extends beyond one year would give the issuer time to make adjustments that would have a favorable effect on its fund balances in future years.

There are two separate safe harbors that seemingly apply to the maturities of TRANs. The first safe harbor sets a two-year maturity limitation. Section 1.148-10(1)(4) provides that one factor evidencing a term that is longer than necessary is whether the term exceeds the safe harbor against replacement proceeds under Section 1.148-1(c)(4). Section 1.148-1(c)(4)(i)(A)(2) provides that replacement proceeds arise when there are available amounts during the period the bonds are outstanding; however, Section 1.148-1(c)(4)(i)(B)(1) establishes a safe harbor that replacement proceeds do not arise for any restricted working capital financings with maturities not longer than two years.

The IRS also explicitly established a separate safe harbor in applying Section 1.148-10 to working capital financings. Specifically, Rev. Proc. 2002-31 provided that TRANs would not be treated as outstanding for longer that reasonably necessary so long as the final maturity date of the issue is not later than the end of the applicable temporary period established under Section 1.148-2(e)(3) of the Regulations. As a practical matter, the result is that the rule provides a safe harbor for TRANs with a maturity date no later than 13 months after issuance.

The separate 13-month and two-year safe harbors have created confusion regarding the maximum maturity that can be used without risking an overburdening and the creation of other replacement proceeds. In making the determination of what is an appropriate definition of short-term, we believe that a two-year maturity limitation is more appropriate and recognizes the special circumstances and limitations under which governmental issuers operate, especially during times that the economy is depressed. Thus, we propose that Rev. Proc. 2002-31 be revoked.

PROPOSAL FOR DEFINITION OF AN ISSUE; PLAN OF FINANCING

The existing Regulations define an "issue" generally as two or more bonds that are (i) "sold at substantially the same time," (ii) that are "sold pursuant to the same plan of financing"

and (iii) that are "payable from the same source of funds." Regulations Section 1.150-1(c)(1). Of these three requirements, the first and the third (i and iii) are objective, while the second ((ii) relating to the plan of financing) is subjective.

The Regulations provide little guidance in determining the appropriate criteria to use in analyzing whether or not bonds are part of a common plan of financing. Indeed, the Regulations simply state that factors to be considered include "the purposes for the bonds and the structure of the financing." Given this lack of direction, in many cases where the first and the third requirements are met, the only safe conclusion is that there is a common plan of financing. This would result in many bonds sold to finance working capital to be treated as part of the same issue as bonds sold at substantially the same time for capital projects, whether long or short-term, and for refunding purposes, whether long or short-term and whether for an advance refunding or current refunding. In some cases, this lack of certainty requires alternative analyses, both as a single issue and as separate issues, because it may not be clear which one is the conservative approach.

However, the Regulations provide some guidance regarding when certain types of working capital bonds are not part of a "common plan of financing" with certain other bonds. Specifically, the Regulations state that "[s]hort-term bonds to finance working capital expenditures and long-term bonds to finance capital projects are not part of the same plan of financing." Therefore, those two types of bonds are not part of the same issue. We believe this type of rule should be expanded explicitly to treat all working capital bonds, whether long or short-term, as not part of a common plan of financing with any other type of bonds. In short, working capital bonds should not be treated as part of the same issue as other bonds, except for other working capital bonds.

Such a rule would eliminate the need to allocate bonds and maturities of an issue between the working capital bonds and the bonds for other purposes. Under the multipurpose issue allocation rules, i.e., Regulations Section 1.148-9(h)(4), in many cases the allocation between refunding and working capital, or between capital assets and working capital, will result in a pro-rata allocation of the bonds. Thus, the working capital bonds will be partly allocated to the longest maturities of the issue, extending the time period for calculating other replacement proceeds as well as affecting the overburdening analysis. The proposed rule change would allow issuers to determine how to schedule the maturities of their working capital bonds in light of the unique issues which drive these types of financings. In many cases, issuers will prefer to schedule the working capital maturities in the early years, to match their expected cash flow recovery. Being forced to allocate some of the working capital bonds to the longest maturities may not comport with the business realities. Moreover, as the maturity limitation rules which apply to refunding bonds and new money capital asset bonds are objective, there should not be a concern with the possibility of abuses. Simply put, if the new money capital asset bonds or the refunding bonds, as the case may be, comply with the maturity limitations applicable to those financings, the issuer should have freedom to structure the maturities of its working capital bonds independently of the capital financing bonds. (See, Proposed Regulatory Changes, Section E.)

PROPOSALS FOR DE MINIMIS WORKING CAPITAL EXPENDITURES

Regulations Section 1.148-6(d)(3) applies the proceeds spent-last-rule to proceeds, including replacement proceeds, to be used to pay for working capital expenditures. This Regulation also provides an exception from the proceeds-spent-last rule for certain "de minimis" types of expenditures. Given that the proceeds-spent-last rule applies to working capital expenditures, there is an implication that items in the list of exceptions are themselves working capital expenditures. However, the list of exceptions includes several items that are capital expenditures. We propose that the Regulations be modified to eliminate any implication that such expenditures are not capital. However, as the determination of whether an expenditure is or is not capital may be difficult, it is useful to continue to have the exceptions enumerated even if some of the enumerated expenditures are usually (or always) capital. The proposed change in the Regulations would simply be to add a parenthetical as follows: "(A) General de minimis exception. Paragraph (d)(3)(i) of this section does not apply to expenditures **(whether capital or working capital)** to pay— ." (See, Proposed Regulatory Changes, Section F.)

One of the de minimis exceptions to the "proceeds-spent-last" rule is intended to allow an issuer to pay qualified guarantee fees and qualified hedge payments (including qualified hedge termination payments) with proceeds of tax-exempt bonds. Most commonly these payments are made from the bond issue covered by the guarantee or hedge. The requirement that the guarantee or hedge be "for the issue" has created problems for issuers. For example, with the demise of some of the larger municipal bond insurers, issuers find that under their bond documents they must replace reserve fund surety agreements or other guarantees. While the payment for these guarantees could have been made from tax-exempt proceeds when the bonds were issued, using proceeds of a new tax-exempt issue to pay these guarantee fees may be problematic under the Regulations. Similarly, issuers may find that they need to make a termination payment for a qualified hedge. If unspent proceeds of the hedged bonds remain, they can be used to pay the termination amount. Also, if the hedged bonds are refunded the termination fee may be paid from the proceeds of the refunding bonds. However, if no unspent proceeds remain, the possible application of the proceeds-spent-last rule may preclude an issuer from making the termination payment with the proceeds of a tax-exempt bond issue issued for the purpose of paying the termination payment.

A similar restriction is found in the Regulations on the financing of issuance costs. Because issuance costs are always (or almost always) known or well estimated when the bonds are issued, that is not as large a concern but has been the cause of some difficulty.

By contrast, the Regulations do not include a similar restriction on payments of qualified administrative costs or payments of rebate or yield reduction payments. Those types of payments may be made using proceeds of another bond issue. Additionally, Regulations Section 1.148-6(d)(3)(ii)(A)(6) and § 1.148-6(d)(3)(ii)(A)(7) each use the phrase "on **an** issue" rather than "on **the** issue" when describing what payments of principal or interest may be paid with certain amounts. Consistency suggests that 1.148-6(d)((3)(ii)(A)(2) be modified to refer to "an issue" rather than "the issue" as it is currently written.

As mentioned earlier, Regulations Section 1.148-6(d)(3)(ii)(A)(5) provides for a de minimis exception for expenditures "that do not exceed 5 percent of the sale proceeds of an issue that are **directly related** to capital expenditures financed by the issue (e.g., initial operating expenses for a new capital project)." (Emphasis added.)

The 5 percent provision has been helpful to issuers, particularly to address situations where there is uncertainty as to whether an expense is capital or working capital in nature. In practice, difficulties have arisen as to whether an expenditure is or is not "directly related" to the capital expenditures being financed by that issue. Accordingly, and particularly given the de minimis nature of the amount (only 5%), it is recommended that the word "**directly**" be removed from this provision of the Regulations. (See, Proposed Regulatory Changes, Section F.)

PROPOSED REGULATORY CHANGES

A. Sizing Reasonable Working Capital Reserves

1. Regulations Section 1.148-1(c)(4)(ii), set forth below, should be deleted in its entirety:

(ii) ***Bonds financing a working capital reserve***

(A) ***In general.*** *Except as otherwise provided in paragraph (c)(4)(ii)(B) of this section, replacement proceeds arise to the extent a working capital reserve is, directly or indirectly, financed with the proceeds of the issue (regardless of the expenditure of proceeds of the issue). Thus, for example, if an issuer that does not maintain a working capital reserve borrows to fund a working capital reserve, the issuer will have replacement proceeds. To determine the amount of a working capital reserve maintained, an issuer may use the average amount maintained as a working capital reserve during annual periods of at least 1 year, the last of which ends within 1 year before the issue date. For example, the amount of a working capital reserve may be computed using the average of the beginning or ending monthly balances of the amount maintained as a reserve (net of unexpended gross proceeds) during the 1 year period preceding the issue date.*

(B) ***Exception to creation of replacement proceeds.*** *Replacement proceeds do not arise under paragraph (c)(4)(ii)(A) of this section with respect to an issue--*

(1) All of the net proceeds of which are spent within 6 months of the issue date under section 148(f)(4)(B)(iii)(I); or

(2) That is not subject to the rebate requirement under the exception provided by section 148(f)(4)(D).

2. Regulations Section 1.148-6(d)(3)(iii)(B) should be revised to read as follows:

(B) ***Reasonable working capital reserve treated as unavailable.*** *A reasonable working capital reserve is treated as unavailable. As a safe harbor, a working capital reserve equal to 5 percent of the actual expenditures of the issuer paid from available amounts in the fiscal year before the year in which the determination of available amounts is made, is reasonable.*

NOTE: The following shows the changes made to this section:

(B) ***Reasonable working capital reserve treated as unavailable.*** *A reasonable working capital reserve is treated as unavailable.* ~~Any~~As a safe harbor, a *working capital reserve* ~~is reasonable if it does not exceed~~equal to *5 percent of the actual* ~~working capital~~ *expenditures of the issuer* paid from available amounts *in the fiscal year before the year in which the determination of available amounts is made*~~. For this purpose only, in determining the working capital expenditures of an issuer for a prior fiscal year, any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures~~, is reasonable*.*

3. The Preamble to the deletion of the above Regulations Section should state that Technical Advice Memorandum 200413012 will not be followed (or that it is being withdrawn), thereby completing the simplification.

B. Anti-Abuse Rules-Other Replacement Proceeds-Remedial Actions

1. The following should be added to Regulations Section 1.148-10(a) as new sub-paragraphs (5) and (6) to incorporate "hedge bond" concepts to remedial action:

(5) ***No overburdening for bonds financing restricted working capital with proper procedures****. Bonds issued to finance restricted working capital will ordinarily not be considered to overburden the tax-exempt market if such bonds are not issued earlier or in a greater amount than is necessary to accomplish the governmental purpose of the bonds and are not to be outstanding in greater than the amount of one year tax-exempt bonds that could have been issued for restricted working capital purposes had the bonds not been issued.*

(6) ***Bonds to be outstanding under a required limit.*** *For purposes of (5), bonds are to be outstanding in an amount that is not greater than the limit prescribed in paragraph (a)(5) if:*

(i) As of the date that the bonds are issued, the issuer of the bonds reasonably expects that such limit will be met; and

(ii) The Issuer has in place adequate procedures for determining if such limit is met; and

(iii) Should the limit not be met, then within 90 days of the date on which the limit is first not met, the issuer takes one of the following remedial actions:

(A) The issuer redeems or cancels bonds in an amount to assure that the limit is met following the redemption; or

(B) The issuer purchases tax-exempt investments in an amount at least equal to 95% of the amount by which the outstanding amount of the Bonds exceeds the limit, and treats such investments as proceeds of the bonds subject to §1.148-6(d)(3)(i) and also subject to Section 149(g)(3)(B) of the Code. In applying the rules of Section 149(g)(3)(B) to such amounts, a certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344 shall be treated as a bond, the interest on which is not includible in gross income under section 103 of the Code and which is not a specified private activity bond (as defined in section 57(a)(5)(C) of the Code)

C. Budget Deficit Working Capital Bonds-Safe Harbor To Avoid Testing

1. The following new definition should be added to as a new provision in Regulations Section 1.148-1:

*(f) **Budget Deficit Working Capital Bonds--***

*(1) **In general**. Budget deficit working capital bonds shall mean bonds issued to pay the costs attributable to budget deficits satisfying the duration and amount limitations set forth below.*

*(2) **Budget deficit.** Budget deficit shall mean the amount by which annual revenues exceed annual expenses for a one year period selected by the issuer.. When determining the size of the budget deficit, an issuer may include a budget deficit from prior years provided that the budget deficit from the prior years have not been financed with tax-exempt bonds that remain outstanding. Financings for the budget deficit from the prior fiscal year with an issue of tax-exempt tax or revenue anticipation bonds may be ignored for purposes of the preceding sentence.*

*(3) **Duration limitation**. For budget deficits:*

(1) not exceeding [3] percent of annual revenues, bonds shall not be outstanding longer than [5] years;

(2) more than [3] percent but not more than [7] percent of annual revenues, bonds shall not be outstanding longer than [10] years;

(3) more than [7] percent but not more than [10] percent of annual revenues, bonds shall not be outstanding longer than [15] years; and

(4) exceeding 10 percent of annual revenues, bonds shall not be outstanding longer than 20 years.

***(4) Amount Limitation.** In no event may bonds be issued as budget deficit working capital bonds if the total amount of such bonds, together with any outstanding budget deficit working capital bonds, would exceed 30% of the actual working capital expenditures of the issuer in the prior fiscal year.*

*(5) **Fiscal Year.** For purposes of this subsection, fiscal year shall mean the one year period utilized by the issuer for accounting purposes or such other one year period consistently used by the issuer for purposes of issuing budget deficit working capital bonds.*

2. The following should be added to Regulations Section 1.148-1(c)(4)(i)(B) as revised above:

***(B) Safe Harbor against creation of replacement proceeds**. As a safe harbor, replacement proceeds do not arise under (c)(4)(i)(A) of this section (1), (2),(3), or–*

(4) For Budget Deficit Working Capital Bonds described in Section 1.148-1(f).

D. Allocation & Accounting Rules

1. The following should be added as a new subsection to Regulations Section 1.148-6(d)(3):

   (iv) Proceeds-spent-last accounting method. Under the proceeds-spent-last method of accounting, internal transfers or loans of amounts that are not available amounts are not taken into account. For example, an available amount deficit exists if working capital expenditures from an issuer's general operating fund exceed the issuer's available amounts and actually are paid with an internal loan to the general operating fund of amounts that are not available amounts. Further, proceeds that are allocated to the general operating fund to repay the internal loan (A) are not allocated to the repayment of the internal loan and (B) are allocated to the original working capital expenditure to the extent the issuer has no available amounts.

2. The following changes should be made to Regulations Section 1.148-6(d)(3)(iii)(A):

   (iii) Definition of available amount.

   (A) In general.
   For purposes of this paragraph (d)(3), available amount means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of an issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts are not proceeds and may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

NOTE: the changes to this section are as follows:

*For purposes of this paragraph (d)(3), available amount means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of an **[delete "the"]** issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts **[add "are not proceeds and"]** may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.*

3. The Preamble accompanying the changes to the above Regulations Sections should state that Technical Advice Memorandum 200446006, dealing with available amounts, will not be followed (or that it is being withdrawn).

E. Change to Definition of an Issue

1. The following changes to Regulations Section 1.150-1(c)(1)(ii) are proposed:

__1.150-1(c)(1)(ii)__. __Sold pursuant to the same plan of finance.__ The bonds are sold pursuant to the same plan of financing. Factors material to the plan of financing include the purposes for the bonds and the structure of the financing. For example, generally –

(B) ~~Short-term b~~Bonds to finance working capital expenditures and ~~long-term~~ bonds to finance capital projects are not part of the same plan of financing; and

F. De Minimis Working Capital

1. Modify Regulations Section 1.148-6(d)(3)(ii)(A) to add the parenthetical as follows:

   *(A) **General de minimis exception.** Paragraph (d)(3)(i) of this section does not apply to expenditures **(whether capital or working capital)** to pay –*

2. Modify Regulations Section 1.148-6(d)(3)(ii)(A)(5) to delete the word "directly"

   *(5) Costs, other than those described in paragraphs (d)(3)(ii)(A)(1) through (4) of this section, that do not exceed 5 percent of the sale proceeds of an issue and that are **[delete "directly"]** related to capital expenditures financed by the issue (e.g., initial operating expenses for a new capital project);*