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## Public Finance Alert

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# IRS ruling allows extraordinary tax-exempt long-term working capital financing

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## A utility was allowed to finance power and gas charges for Winter Storm Uri without dealing with the tough tax rules on working capital—but how?

### What's the Impact?

- IRS spared tax-exempt bonds issued by the City for the Utility from both the proceeds-spent-last rule and the test-and-invest safe harbor.
- The charges for backup power and gas were "extraordinary, nonrecurring items" that were exempt from the PSL rule.
- The tax-exempt bonds would not be "outstanding longer than reasonably necessary."
- Although the ruling does not have sufficient detail to allow issuers to structure transactions around it, the reasoning of the ruling may help issuers craft a ruling request of their own along similar lines when appropriate.

The IRS recently issued a private letter ruling that blesses a tax-exempt long-term working capital financing for costs related to Winter Storm Uri. As many readers know, it's hard to do a tax-exempt long-term working capital financing. (Not as hard as going without water and power

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for a few days when the power grid freezes and the pipes freeze and you're trying to flush toilets with rainwater and it's a Three Dog Night, but you only have one dog (who, bless her heart, is generating only about 0.3 Dogs of warmth because she keeps getting up to shiver). But still, it's hard.)

There are two big issues that you must deal with in a long-term working capital financing.

- The first is the "proceeds spent last" (PSL) rule: You can treat the proceeds of the bonds as spent only if you have no other "available amounts"[1] to pay for the things you want to pay for with the bonds. (Importantly, merely paying the proceeds to a third party doesn't work and, in fact, leaves you worse off.)
- Second, the anti-abuse rules: Even if you can get your proceeds spent for tax purposes, you typically can't leave the bonds outstanding for longer than 13 months unless you test for available amounts every year and use them to redeem tax-exempt bonds or invest them in other tax-exempt bonds (or their economic equivalent) or demand deposit SLGS. We can call this the "test and invest" approach (because it rhymes, and life is short, and one must find a modicum of delight wherever one can). It's technically only a safe harbor. However, the "unqualified" level of confidence required for tax-exempt bond opinions magically turns many safe harbors, including this one, into ironclad rules.

These rules, which apply until the tax-exempt bonds are paid off, are colossal pains in the neck that only a tax lawyer could love and consign many a long-term working capital financing to the shabby and unenlightened corner of the municipal market inhabited by taxable deals.

Although private letter rulings are expensive ($38,000, and that's just the cover charge at the door) and time-consuming endeavors, they can be worthwhile investments. The "City" and the "Utility" described in a recent IRS private letter ruling (PLR 202309014) probably agree. In that ruling, the IRS spared tax-exempt bonds issued by the City for the Utility from both the PSL rule and the test-and-invest safe harbor. Specifically, the IRS ruled that the Utility could use tax-exempt bonds to refinance the costs of buying replacement power and gas to deal with an "Occurrence" (which the ruling does not define, but which we can safely assume was Winter Storm Uri) without complying with the onerous PSL rule. Further, the IRS ruled that the bonds were not outstanding longer than necessary under general principles, meaning that the Utility didn't have to use the test and invest safe harbor.

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[1] Generally speaking, "available amounts" are non-borrowed cash, investments, and other amounts of the issuer or any related party to the issuer that can be used for the working capital expenditures that the issuer wants to finance with the tax-exempt bonds without legislative or judicial action requiring the funds to be spent and without a requirement that they be reimbursed. You can exclude a "working capital reserve" (which doesn't actually have to be kept in an account called "Working Capital Reserve"), and a 501(c)(3) organization can generally exclude its endowment if the endowment meets certain criteria.

## Facts

Before we dig into the excruciating federal tax law points in play in the ruling, we first need to lay out the factual background because the law that governs here is especially dependent on the facts.

Winter Storm Uri came rolling in overnight on Valentine's Day in 2021, battering Texas and Oklahoma and places far beyond. We woke up in Houston to a blanket of snow and did the only appropriate thing—went outside to throw it at each other. As we walked out, we heard the power to the house click off. We thought nothing of it and certainly didn't think that we would spend the next week running from one house to another, fleeing power outages and frozen pipes. The 3-year-old was thrilled to get to see snow (for about 8 minutes until he got too cold). As for the ensuing week, the less said about it, the better. It was all, in a word, *extraordinary*.

Generation, transmission, and distribution facilities for power and gas froze and failed. Backup supplies did too. The shortage left utilities scrambling to buy power and gas from other providers. The Utility in the private letter ruling had to pay a premium for the backup power purchased from the surrounding power grid (13x above the budgeted rate) and gas (60x (!) above the budgeted rate) because shortages were so widespread. To make matters worse, many other utilities were so battered by Uri that they left the market altogether or were forced into bankruptcy. The Utility in the ruling stayed in the market, and the deal it had struck with the grid operator allowed the grid operator to force the utilities that remained to pay for the share of costs that would have been borne by those that left. (Referred to as "uplift charges," these are an ordinary part of the power distribution business, but they skyrocketed because Uri forced so many utilities out.) The Utility sued the grid operator, claiming that the charges were excessive. At the time that the IRS issued the private letter ruling, most of the litigation had been resolved. The Utility expected that the rest would be resolved soon thereafter, which would tell the Utility the final amount that it owed for the backup power and gas.

In the meantime, the Utility financed the various power and gas charges with taxable commercial paper. They refinanced some of it with long-term taxable debt, which they could do because the City had determined that the charges were a "regulatory asset" under the accounting rules so that the Utility could put them on its balance sheet rather than its income statement and could recover the costs through ratepayer charges. The Utility then sought a ruling from the IRS that would allow them to refinance the rest of it with long-term tax-exempt debt. Because the charges for power and gas are considered to be working capital expenditures, however (notwithstanding their treatment as a regulatory asset recoverable over a period of years for accounting purposes), the IRS would have to rule favorably on the two key questions that come up in every working capital financing, as noted above: (1) when the proceeds can be treated as spent and (2) how long the bonds can be outstanding.

On the first point, the City and the Utility didn't want to deal with the PSL rule, so they asked the IRS to rule that the expenditures met the "extraordinary item" exception from the PSL rule. On the second point, the City and the Utility didn't want to deal with the test-and-invest harbor, so

they asked the IRS for a ruling that the bonds would not be outstanding longer than necessary (the rule for which the test-and-invest approach serves as a safe harbor).

## Analysis

### *The charges for backup power and gas were "extraordinary, nonrecurring items" and, thus, exempt from the PSL rule.*

The IRS first ruled that the charges qualified for the exception from the PSL rule that applies to "extraordinary, nonrecurring items that are not customarily payable from current revenues," for which no reserve is maintained. Therefore, the proceeds of the tax-exempt bonds could be allocated to refinancing the power and gas charges even if the Utility had available amounts that could otherwise be used to pay them.

In reaching that conclusion, the IRS first dismissed the contention that a separate exception from the PSL rule for refunding proceeds could have applied to the tax-exempt bonds (which were, after all, refunding bonds). The IRS ruled, rather obliquely, that the refunding exception did not apply because, in essence, the IRS applies the working capital rules to refunding bonds and new money bonds in the same way.[2]

The IRS then moved on to the specific language of the exception from the PSL rule for extraordinary items. Specifically, this exception applies to expenditures that are "extraordinary, nonrecurring items that are not customarily payable from current revenues." It is not altogether clear whether it is best to think of this as three separate requirements or as three synonyms for the same idea. (I suppose it is conceivable that an expenditure could be extraordinary and nonrecurring but similar enough to the type of expenditures that are customarily paid from current revenues (and perhaps different only in degree and not in kind from their "ordinary and recurring" cousins) that it would fall outside of the exception.) The IRS has taken the position in the past that to qualify for this exception, an expenditure must be neither discretionary nor voluntary.[3] In addition, for the exception to apply, if the issuer or a related party to the issuer maintains a reserve for these expenditures (such as a "self-insurance fund," the regs say), those amounts must be allocated to the extraordinary expenses before the bond proceeds can be allocated to them.

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[2] Specifically, the IRS ruled that, to the extent that there were unspent proceeds of the taxable commercial paper that the Utility initially used to pay the power and gas charges, those proceeds would become transferred proceeds of the tax-exempt refunding bonds, and because they would not then be used to pay principal and interest on debt but would instead be used to pay for the charges, they could not qualify for the refunding exception. In addition, to the extent that the proceeds of the taxable commercial paper had already been spent (in the sense that those dollars were already out the door), they could be allocated to the power and gas charges only to the extent that those expenditures satisfied the PSL rule.

[3] See PLR 9509035, known colloquially to us as the "Columbus Ruling;" it is worth noting that this assertion by the IRS fell by the wayside in the convoluted procedural history of the litigation that followed the ruling, but the IRS's position makes sense.

The regulation gives us two examples of expenditures that qualify for the exception—"casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage" (which could be read to refer to insurance *that is reasonably available*, even if the issuer imprudently fails to obtain it). Beyond the language of the regulation, there is little guidance that interprets the extraordinary item exception. We have some examples of what might work:

- Expenditures to help NYC recover from the terrorist attacks of September 11, 2001[4]
- Expenditures relating to state insurance industry and state insurance fund insolvencies (no specific guidance, but many of these transactions have been done)
- Potentially, expenditures relating to COVID-19 recovery efforts (NABL and others asked the IRS for guidance saying so but never got it), although the mountain of COVID-relief cash from the federal government has made working capital borrowings for these expenditures largely unnecessary

Turning to the facts of Winter Storm Uri, the IRS ruled that "[t]he damage caused by [Uri] resulted in unprecedented power losses, which in turn resulted in substantial and unprecedented increases in Utility's cost of electric power and natural gas." The Utility's operating reserves were not kept for expenditures such as the power and gas charges. Moreover, the Utility had no legal right to use the operating reserves maintained by the City, so neither the Utility's nor the City's reserves needed to be spent first before the bond proceeds could be spent.

A final point on this part of the analysis—although the regulations mention expenditures for "extraordinary legal judgments" as an example of expenditures that can be extraordinary working capital items—the fact that the Utility sued to reduce the amount of power and gas charges that it owed is a bit of a red herring. Even if the Utility had not sued the grid operator, it could have financed the power and gas charges as extraordinary items not subject to the PSL rule—the litigation was not critical to that conclusion.

Having resolved the first major question that arises in long-term tax-exempt working capital financings, the IRS turned to the second major question: Sure, you got your proceeds spent, but now you want to leave your bonds outstanding for *how long*?

### *The tax-exempt bonds would not be "outstanding longer than reasonably necessary."*

The federal government does not want issuers to leave tax-advantaged bonds outstanding longer than is reasonably necessary to accomplish the purpose of the bonds. This principle is enforced through several overlapping sets of rules. One set of rules provides that "other replacement proceeds" will arise with respect to an issue of bonds "to the extent that the issuer reasonably expects as of the issue date that: (1) the term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue;[5] and (2) there will be available amounts during the period that the issue remains outstanding longer than necessary." (Note

[4] See PLR 200210006.

[5] As determined under Treasury Regulations section 1.148-10.

here that the concept of available amounts sneaks back into the analysis even if you can ignore them for purposes of treating the proceeds as spent by qualifying for the extraordinary item exception.) While the potential dangers of "other replacement proceeds" seem nebulous, they are very real; funds of the issuer, such as taxes or other revenues, that were never expected to be subject to the tax rules suddenly—*presto!*—must follow them. If an issuer can still comply with the tax rules in this circumstance, it might be more a matter of luck than skill or of the fact that the issuer doesn't have a whole lot of cash.

How do we know whether bonds are outstanding "longer than is reasonably necessary" for this purpose? It is "determined based on all the facts and circumstances," and "considerations include the nature of the event giving rise to the expenditures, the size of the expenditures relative to the size of a borrower's budget, and the impact of the expenditure on a borrower's operating budget over the term of the issue that will finance the expenditures." In other words, it's the sort of multifactor balancing test that public finance tax lawyers hate because it's hard to get to the "unqualified" level of confidence that our market requires.

So, in nearly every case, we insist that the issuer of tax-exempt long-term working capital bonds abide by the test test-and-invest safe harbor. The safe harbor (which is the regulatory codification of the "Richmond School District Ruling"[6]) provides generally that an issuer must test for available amounts in the first 90 days of each "bond year" (which usually begins on the issue date) while the bonds are outstanding. Then, if there are any available amounts, the issuer must use them either to redeem non-AMT tax-exempt bonds (either the working capital financing bonds or other bonds of the issuer) or acquire non-AMT tax-exempt investments (including interests in a mutual fund that primarily holds tax-exempt bonds or demand deposit SLGS). To repeat, although styled as a safe harbor, because of the desire for certainty by issuers and bond counsel, it is typically applied as an affirmative rule.

But complying with this rule takes a lot of time, money, and brain power from a lot of people who could all be doing much better things with their time, and it is to be avoided where possible because it can result in the issuer having to take its own funds needed for its actual governmental purposes and use them to pay off its own bonds or invest them at typically lower tax-exempt rates. The City and the Utility agreed, and that's why they sought this ruling.

The IRS concluded that, under the general rule, the tax-exempt bonds issued to refund the taxable debt that initially financed some of the charges were not outstanding longer than necessary based on all the facts and circumstances, and the Utility didn't have to test and invest. The City argued (and the IRS agreed) that issuing the tax-exempt bonds with a term of "n" years and a weighted average maturity of not more than "o" years[7] was reasonable because:

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[6] PLR 9424043.

[7] ("Oh," not "zero.") The WAM and final maturity would be helpful for the rest of us to know, and they are seemingly neither prejudicial to (nor insufficiently protective of the identity of) the City and the Utility, but they were lost to the pitiless redaction machine, which zealously protects issuer privacy. Perhaps the drafters of the ruling request will let these facts slip someday.

- Perhaps as a reflection of the fact that the charges were a regulatory asset for accounting purposes, the longer term of the bonds allowed the Utility to spread out its debt service expense and thereby made it more bearable than compressing it into the short maturity schedule otherwise demanded by the working capital financing rules.
- It considered the overall economic impact of Winter Storm Uri and the charges.
- It allowed the Utility to avoid further downgrades of its credit rating.
- It allowed the Utility to avoid further increasing rates to its customers to pay for the financing of the charges (the only source of repayment for the tax-exempt bonds was utility revenues from the Utility's customers).
- It allowed the Utility to keep its budget somewhat intact.

## Takeaways and Potential Application

So, a wise investment in a PLR allowed the City and the Utility to avoid the difficult questions of the PSL rule and the maturity limitations on working capital financings. What does the ruling tell the rest of us?

- While the details in the ruling may be too scant to provide difference-making guidance to other issuers,[8] the ruling is a helpful addition to the body of law governing long-term working capital financings.
- The ruling provides beneficial insight that may encourage others to seek a similar ruling or provide sufficient comfort to render a tax opinion in similar circumstances.[9]
- Specifically, an issuer who finds itself in a similar circumstance could use the facts and considerations in this ruling as guideposts for facts to research and include in a ruling request.
- For example, an issuer still uncertain whether, when, and to what extent it will recover from the after-effects of COVID-19 could consider whether a tax-exempt long-term working capital financing might be a good subject for a ruling (notwithstanding the potential presence of COVID-19 relief moneys) if it projects a continued depression of tax and other revenues and cannot finance them on a short-term basis without blowing through its budget, sharply increasing taxes or fees to its constituents, and/or ruining its credit rating.

[8] Yeah, yeah, yeah, "PLRs aren't precedent." You know what we're going to say next—the Supreme Court has ruled that they are helpful to show the position of the IRS, the IRS can't disavow otherwise persuasive reasoning just because it's in a PLR, etc.

[9] Though we can hope that the circumstances surrounding Winter Storm Uri remain extraordinary in the literal sense.

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