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Tax Anticipation Notes: An Option to Alleviate Municipal Cash Flow Shortages Due to the COVID-19 Outbreak

As a result of the governmental and business shut downs employed to ease the outbreak of COVID-19, municipalities face the grim possibility of reduced or delayed revenues resulting in cash flow shortages. Faced with lower and/or slower tax collections, municipalities will still need to meet current operating expenses. Short-term tax anticipation notes (TANs) may be a means to bridge this timing gap.

Connecticut municipalities, as well as any political subdivision empowered to lay taxes, are authorized to issue notes in anticipation of their receipt of tax collections. *See Conn. Gen. Stat. § 7-405a.* TANs are authorized by resolution or ordinance adopted by the municipality's legislative body and are limited to the amount required to pay current expenses and obligations. TANs may be renewed from time-to-time, but all TANs must mature and be payable by the end of the fiscal year in which the applicable tax collections are payable. The amount of TANs issued is limited to the total levy of the then current fiscal year. However, if no tax levy has been made at the time of issue, the size is limited to the tax levy of the prior fiscal year.

For purposes of authorizing TANs, a municipality's legislative body is: (1) for towns, the town meeting; (2) for cities, the board of aldermen, the city council or other body charged with the duty of making annual appropriations; (3) for boroughs, the board of burgesses; and (4) for municipal districts, the district committee or other body charged with the duty of making annual appropriations. *See Conn. Gen. Stat. § 1-1(m).*

In order to issue TANs on a federally tax-exempt basis, additional requirements must be met. TANs are working capital financings, which are governed by the arbitrage regulations, more specifically those concerning replacement proceeds, temporary periods and accounting rules. These regulations determine both the sizing and the required method for accounting for expenditures.

The proceeds derived from a short-term working capital borrowing are generally permitted a 13-month temporary period. *See Treas. Regs. § 1.148-2 and Rev. Proc. 2002-31.* During a temporary period, the proceeds are permitted to be invested without any restriction as to yield, provided the issuer reasonably expects to spend those proceeds within the 13-month temporary period. As such, TANs should be sized to meet this 13-month spending requirement.

In order to meet the 13-month spending requirement, the municipality must demonstrate that, absent the issuance of the TANs, a zero balance or operating cash flow deficit would have occurred during the period the TANs are outstanding. The timing of the expenditures is determined by the application of a "proceeds-spent-last" accounting rule. *See Treas. Regs. § 1.148-6.* Pursuant to this rule, proceeds cannot be considered spent until there are no "available amounts" that could be used in place of those proceeds. "Available amounts" are, subject to limited exclusion, generally funds available to the issuer to pay the type of working capital expenditure being financed. However, a municipality is permitted to maintain a "working capital reserve." The amount in this reserve is limited to 5 percent of the sum of the municipality's working capital expenditures plus capital expenditures paid out of current revenues during the preceding fiscal year. In addition, the amount in the reserve may not exceed the municipality's average balance of "available amounts" during prior annual periods of at least one year.

The 13-month period is also within the safe harbor provided in the regulations against the creation of "other replacement proceeds," which can be the product of an issue being outstanding for a period that is longer than necessary. *See Treas. Regs. § 1.148-1.*

Even though the statutory time limitation for paying off a TAN should result in the issue meeting the 13-month temporary period, consideration still must be given to the amount expected to be expended during that period when determining the issue's size.

TANs are a borrowing and not a replacement for lost revenues, they do address the timing issues created by delays in revenue collections. For more information, please contact any of the municipal finance attorneys at Day Pitney.

For more Day Pitney alerts and articles related to the impact of COVID-19, as well as information from other reliable sources, please visit our COVID-19 Resource Center.

COVID-19 DISCLAIMER: As you are aware, as a result of the COVID-19 pandemic, things are changing quickly and the effect, enforceability and interpretation of laws may be affected by future events. The material set forth in this document is not an unequivocal statement of law, but instead represents our best interpretation of where things stand as of the date of first publication. We have not attempted to address the potential impacts of all local, state and federal orders that may have been issued in response to the COVID-19 pandemic.

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