September 2018 update on FY 2019 federal budget sequestration affecting build America bonds and other direct pay subsidy bonds

Hinckley Allen Public Finance

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Earlier this summer, the Internal Revenue Service announced that the percentage reduction, or budgetary sequestration rate, that will be applied to interest subsidy payments on so-called “direct-pay” bonds for fiscal year 2019 (which begins on October 1, 2018) will be 6.2 percent. The sequestration rate on such subsidies for the current fiscal year is 6.6 percent. Under current law, direct pay bond subsidy payments are subject to federal budgetary sequestration through fiscal year 2027. The sequestration rate for federal fiscal years 2020 through 2027 will be set from time to time in the future, unless Congress takes action to change or eliminate the budgetary sequestration process.

The types of direct pay subsidy bonds affected by federal budgetary sequestration include build America bonds (BABs), recovery zone economic development bonds, qualified zone academy bonds, qualified school construction bonds, qualified energy conservation bonds and new clean renewable energy bonds.

The Office of Tax Exempt Bonds within the Internal Revenue Service (IRS-TEB) has previously advised that issuers of direct pay subsidy bonds should complete IRS Form 8038-CP as directed in the instructions for the form, claiming the full amount of the direct pay subsidy to which they would be entitled absent sequestration. IRS-TEB has also advised that issuers will receive correspondence concerning their subsidy payment reduction after they file Form 8038-CP. IRS-TEB encourages issuers with questions about the status of direct pay subsidies requested on Form 8038-CP, including any sequester reduction, to call IRS Customer Account Services at (877) 829-5500.

As has been noted previously, in light of the ongoing federal budgetary sequestration process, issuers of direct pay subsidy bonds may wish to consider whether and to what extent they are currently in a position to exercise a special, extraordinary or other optional call right (if any) provided under the terms governing their direct pay subsidy bonds. The answer to this question will turn in part on the specific provisions establishing the call right in the governing bond documents or statutory authorization, and on the economics of refinancing the direct pay subsidy bonds from other sources, such as an issue of tax-exempt bonds—including the cost of any redemption premium associated with calls of such direct pay subsidy bonds.

Please contact Antonio Martini directly at 617-378-4136, or any other member of Hinckley Allen's Public Finance Practice Group for more information about the ongoing federal budgetary sequestration process, or if you have any other bond compliance matter you would like to discuss.

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