

Client Alert

March 2013

Sequester Reduces Subsidies on Direct Pay Bonds

Sequester in Effect

As a result of the “sequester provisions” of the Budget Control Act of 2011 and the American Taxpayer Relief Act of 2012, on March 1, 2013, President Obama issued an Executive Order (the “Order”) making certain automatic reductions to the budgetary authority in departments within the Federal government in amounts calculated by the Office of Management and Budget in a report also dated March 1, 2013 (the “OMB Report”). The OMB Report includes up to 8.7 percent reductions in the subsidy payments for six types of outstanding municipal bonds (“Direct Pay Bonds”):

- **Build America Bonds (“BABs”)** – issued between February 17, 2009, and December 31, 2011, under Sections 54AA and 6431 of the Internal Revenue Code of 1986, as amended (the “Code”), with 35 percent interest subsidies from the federal government
- **Recovery Zone Economic Development Bonds (“RZEDs”)** – issued between February 17, 2009, and December 31, 2011, under Sections 54AA, 1400U-2 and 6431 of the Code, with 45 percent interest subsidies from the federal government
- **Qualified Zone Academy Bonds (“QZABs”)** – issued after March 17, 2010, under Sections 54E and 6431 of the Code, with an interest subsidy equal to the lesser of the actual interest paid or the amount of interest that would have been payable if calculated at the applicable qualified tax credit bond rate found at www.treasurydirect.gov as of the date of a binding agreement to purchase the bonds (the “Tax Credit Rate”)
- **Qualified School Construction Bonds (“QSCBs”)** – issued after March 17, 2010, under Sections 54F and 6431 of the Code, with an interest subsidy equal to the lesser of the actual interest paid or the amount of interest that would have been payable if calculated at the applicable Tax Credit Rate
- **New Clean Renewable Energy Bonds (“New CREBs”)** – issued after March 17, 2010, under Sections 54C and 6431 of the Code, with an interest subsidy equal to the lesser of the actual interest paid or the amount of interest that would have been payable if calculated at 70 percent of the applicable Tax Credit Rate
- **Qualified Energy Conservation Bonds (“QECBs”)** – issued after March 17, 2010, under Sections 54D and 6431 of the Code, with an interest subsidy equal to the lesser of the actual interest paid or the amount of interest that would have been payable if calculated at 70 percent of the applicable Tax Credit Rate

On March 4, 2013, the Tax-Exempt Bond office of the Internal Revenue Service (the “IRS”) issued initial guidance for the sequester. Subject to clarification and the possibility of Congressional action, **issuers of Direct Pay Bonds face reductions of up to 8.7 percent of the subsidy amounts** through the end of the current federal fiscal year on September 30, 2013.

Possible Impacts on Issuers

Filing for Subsidies Under the Sequester. In accordance with the requirements of the IRS, issuers of Direct Pay Bonds are required to submit a Form 8038-CP (either directly or through filing agents) at least 45 but not more than 90 days prior to each interest payment date for fixed rate bonds or variable rate bonds if the interest amount to be paid is known. When the payment amounts are not known in advance (most variable rate bonds), the submission is for reimbursement in arrears at the end of each quarter within 45 days after the last payment date in the quarter.

The March 4, 2013, IRS guidance provides instructions to issuers for filing for direct payments after March 1, 2013. Issuers are to complete Form 8038-CP in accordance with the current Form 8038-CP instructions (dated January 2012), using the amounts originally expected to be paid by the U.S. Treasury. Affected issuers will then receive a letter or some other form of correspondence indicating that a portion of their requested payment was subject to the sequester reduction, and indicating the amount of that reduction. See [Effect of Sequestration on Certain State & Local Government Filers of Form 8038-CP](#) on the [Tax Exempt Bonds Homepage](#) of [IRS.gov](#).

In order to have as much time as possible to deal with the precise amount of any reduction, issuers should consider filing for the subsidy as soon as permitted — that is, 90 days in advance of the payment date for fixed rate bonds and immediately after each quarter for most variable rate bonds.

Redemption Provisions of Direct Pay Bonds. Many of the documents under which Direct Pay Bonds were issued include language that permits the issuer to redeem or prepay those bonds early in the event the subsidy from the federal government is eliminated or reduced. In a few circumstances, we have seen language that requires an issuer to redeem bonds if the subsidy is eliminated or reduced. Therefore it is important for each issuer of Direct Pay Bonds to review the related bond documents to determine whether the reduction in the subsidy triggers a redemption, and, if so, whether that redemption is at par or requires a make-whole payment or a prepayment premium.

Event Disclosure. For almost all issuers, it will be true that the issuer is obligated to make full payment to its bondholders regardless of the sequester reduction. For any Direct Pay Bonds that are subject to a continuing disclosure agreement that requires reporting of material events, the issuer must consider whether the reduction in the subsidy payments as a result of the sequester is likely to have a material adverse effect on the issuer's ability to make interest payments. Further, a decision needs to be made as to whether the reduction in subsidy is likely to result in an unscheduled draw on a debt service reserve fund. If the issuer misses an interest payment or an unscheduled draw on the reserve fund occurs, the issuer would be required to file an event notice with the Electronic Municipal Market Access system ("EMMA) under the issuer's continuing disclosure obligation. An event notice does not need to be filed simply indicating that the subsidy has been reduced.

If you have any questions about BABs, Recovery Zone Bonds, QZABs, QSCBs, New CREBs or QEGBs that may be affected by the sequester provisions, please contact us.

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