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Shutdown Halts Rebates on Build America Bonds, Dents Appeal.

(Reuters) – The inability of the U.S. Treasury to send Build America Bond payments to state and local governments during the federal government shutdown is the latest blow to hopes these securities might grow into an alternative to tax-exempt municipal bonds.

Taxable Build America Bonds, created in the 2009 economic stimulus plan, pay issuers federal rebates equal to 35 percent of the bonds' interest costs. The rebates were so attractive that state and local governments rushed to sell $181 billion BABs in the 20 months of the program's existence.

When the BABs program expired with the end of the stimulus plan, issuers pushed to bring it back or create a similar form of taxable debt with rebates, often also called "direct-subsidy."

Since the government shutdown began on October 1 because of a budget impasse in Congress, all tax refunds have been halted, including BABs rebates.

It is the latest complication to make issuers skeptical of proposals for new direct-subsidy bonds because many say the bonds entangle state and local governments in federal budget fights that jeopardize their funds.

The across-the-board spending cuts known as sequestration that started this spring sliced into all BABs rebates. Issuers had believed rebate amounts were guaranteed and were dismayed to find they could shrink. On Monday, the day before the shutdown began, the Internal Revenue Service said that year-two sequestration cuts would trim BABs payments by 7.2 percent.

"We've already gone through this drill with sequestration," said Chris Mier, managing director of analytical services for Loop Capital Markets, about the suspension of rebates.

The Government Finance Officers Association, the largest organization representing issuers, could not say how many issuers were expecting rebates during the shutdown. There is no central calendar of BABs interest payments or rebates. Recent IRS statistics show that in 2010, the last year data is available, issuers received $1.78 billion total in BAB rebates.

About 90 days before an interest payment is due, an issuer formally requests the rebate and then receives it typically 30 days before the payment date, according to Utah Treasurer Richard Ellis.

Like many issuers, Utah does not use the rebates to cover its interest payments due in January and July. It has set aside enough funds for interest costs and then treats the rebates as additional revenues, said Ellis.

Most at risk from the suspension would be to small issuers such as remote school districts that also apply the rebates to the interest payments and have payments due soon, Loop Capital's Mier said.

President Barack Obama has pushed for an alternative to traditional tax-exempt municipal bonds, arguing they cost the federal government more than they benefit local governments. Obama has suggested creating more direct-subsidy debt programs and also capping the tax exemption on municipal bonds, which would drive down the demand for them.

Richard Ciccarone, a managing director at McDonnell Investment Management, said the current payment suspension shows direct-subsidy bonds make states and cities too dependent on the federal government.

Issuers should see “they have a strong interest in preserving the current tax-exemption structure,” he said.

Asked if he would ever push for Utah to issue direct-subsidy bonds should they reappear, Ellis, the state treasurer, said: “I wouldn’t.”