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Transitions From IBOR to Alternative Rates Avoid Tax Under Proposed Regulations

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Recently proposed U.S. treasury regulations confirm that replacing interbank offered rates with alternative reference rates in certain financial instruments will not be treated as taxable events for U.S. federal income tax purposes. The proposed regulations anticipate the elimination of LIBOR and the emergence of replacement benchmark rates in new and existing financial contracts. They are a welcome addition to the regulatory landscape as markets begin to transition substantial amounts of debt instruments and derivatives away from LIBOR and into alternative reference rates.

Summary

On October 8, 2019, the U.S. Treasury Department (Treasury) and the Internal Revenue Service (IRS) issued proposed regulations confirming that transitions from the London Interbank Offered Rate (LIBOR) and other interbank offered rates (IBORs) to alternative reference rates in debt instruments and derivatives will not be taxable events. This guidance was eagerly anticipated because countless instruments will have to be amended to provide for new reference rates before IBORs are phased out as early as the end of 2021. If these amendments were treated as significant modifications for U.S. tax purposes, they could have a wide range of adverse tax consequences for market participants, as described below.

Background

Coming Demise of IBORs as Reference Rate. In 2012, global regulators began looking at the potential for transitioning financial markets away from IBORs, including USD LIBOR, due to concerns about the significantly

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reduced liquidity in the market for the underlying transactions on which the IBORs are based (that is, unsecured wholesale term lending to banks).[1] Panel banks that provided the estimates of IBORs were increasingly reluctant to do so because of the narrow transaction base as well as the litigation risk arising from claims of manipulation.[2] Many of these banks continued to provide quotes only because of pressure from regulators who wanted to minimize sudden disruption of the IBOR markets; all panel banks responsible for fixing LIBOR have agreed to continue to support the determination of LIBOR by providing LIBOR quotes through the end of 2021.[3] However, the U.K.'s Financial Conduct Authority (FCA), the regulatory authority that supervises the LIBOR administrator, has indicated that it would no longer persuade or obligate panel banks to provide LIBOR quotes after 2021. As a result, it is expected that LIBOR may no longer be published by the end of 2021, and perhaps sooner.[4] The elimination of LIBOR could affect the liquidity and normal operation of multiple markets in which USD LIBOR financial instruments are issued and traded. For example, USD LIBOR is used commonly for mortgages, corporate loans, public debt securities, and derivatives (such as interest rate swaps), and serves as a reference rate for approximately $35 trillion of debt and derivatives.

Development of New Benchmark Rates. Given the expectation that LIBOR will not be available after 2021, many industrialized countries have been developing new benchmark rates to replace LIBOR. For example, in the United States, the Federal Reserve Board of Governors and the Federal Reserve Board of New York (FRBNY), with cooperation from the Treasury, the U.S. Commodity Futures Trading Commission, and the Office of Financial Research, jointly sponsored the Alternative Reference Rates Committee (ARRC).[5] On June 22, 2017, the ARRC announced that it had selected a broad

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[1] Versions of IBORs other than LIBOR include Euro Interbank Offered Rate ("Euribor"), the Tokyo Interbank Offered Rate (TIBOR), and the Canadian Dollar Offered Rate (CDOR).

[2] A number of leading international banks and financial institutions were accused of adjusting their submissions to manipulate the LIBOR benchmark and were required to pay billions of dollars in fines and settlements.

[3] In a July 15, 2019, speech, Andrew Bailey, Chief Executive of the FCA, noted that it is expected that many panel banks will cease providing quotes at the end of 2021, which could result in any remaining panel banks being unable to produce a sufficient or representative rate. See "LIBOR: Preparing for the End," available at https://www.fca.org.uk/news/speeches/libor-preparing-end.

[4] On July 27, 2017, the FCA announced that all currency and term versions of LIBOR, including USD LIBOR, could be phased out after the end of 2021. See Andrew Bailey, "The Future of LIBOR," available at https://www.fca.org.uk/news/speeches/the-future-of-libor. Previously, the U.K. had adopted the E.U. Benchmarks Regulation in 2016 requiring oversight of certain IBORs; most of the provisions came into effect on January 1, 2018.

[5] See ARRC Guiding Principles, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-principles-July2018.pdf.

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Treasuries repo financing rate as its recommended alternative reference rate for USD derivative and financial contracts.[6] As of April 3, 2018, the FRBNY (as administrator) began publishing the broad Treasuries repo financing rate as the Secured Overnight Financing Rate (SOFR). Public offerings of new debt instruments using SOFR as the benchmark interest rate are appearing in the public debt markets.[7]

Existing financial instruments, including outstanding debt instruments and interest rate swaps with terms extending beyond 2021, will need replacement rates for LIBOR. While many financial instruments contain provisions for replacing the existing rate identified in the instrument, it is widely acknowledged that existing contracts referencing benchmarks such as LIBOR do not contain robust provisions that address the potential permanent discontinuation of a benchmark and often lead to undesirable or uncertain results. Accordingly, outstanding financial contracts (including debt instruments such as loans and mortgages as well as derivatives) that are based on LIBOR (including USD LIBOR) may need to be amended to deal with the elimination of LIBOR and the potential deficiencies in the instruments' existing contract provisions for replacing the primary rate. Many industry groups, including the International Swaps and Derivatives Association (ISDA), recognize the need to develop contractual language to provide for a means of transitioning new and existing agreements to SOFR following a discontinuance of LIBOR. These efforts seek to standardize contract language that defines (1) the trigger events that will cause a discontinued benchmark (for example, USD LIBOR) to no longer apply to a transaction and (2) the replacement benchmark (for example, SOFR) that will thereupon apply to the transaction.

The U.S. Tax Problem

Potential for "Significant Modification" of Contracts. The anticipated discontinuation of LIBOR and accompanying contract amendments raise a central U.S. federal income tax issue: whether an amendment to an existing contract to address the loss of LIBOR constitutes a deemed exchange under Section 1001 of the Internal Revenue Code (Code). Treasury Regulations Section 1.1001-1(a) provides, among other things, that gain or loss is realized from "the exchange of property for other property differing materially either in kind or in extent." Treasury Regulations Section 1.1001-3(b) generally provides that a "significant modification" of a debt instrument results in

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[6] See "ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate" (Press Release, June 22, 2017), available at https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf.

[7] For an example of a recent public offering, see https://www.sec.gov/Archives/edgar/data/895421/000090514819000620/efc19-410_424b2.htm.

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a taxable exchange of the pre-existing debt instrument for the modified debt instrument. Treasury Regulations Section 1.1001-3(c) defines a modification as generally "any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument." A "significant" modification is generally one that is economically significant and happens if (1) the modification does not occur by operation of the terms of the debt instrument and (2) the modification changes the debt instrument's yield by more than the greater of (x) 0.25 percent and (y) 5 percent of the unmodified yield.[8] It is not always clear how to apply these rules.

In the non-debt context, there are no bright-line rules for what constitutes a significant modification giving rise to a deemed exchange. Accordingly, any modification is at risk of being treated as a significant modification.

Possible Adverse Tax Consequences. In the spring of 2019, various industry groups submitted letters to the Treasury and the IRS requesting guidance on whether amendments that transition from LIBOR to a replacement rate and that are made to debt instruments or other existing contracts such as derivatives should be treated as a "significant modification."[9] In general, these groups expressed concern that the tax law was unclear on this issue, and absent guidance from the Treasury and the IRS, the treatment of reference rate amendments as significant modifications would have significant and adverse tax effect on the parties to the amended instruments. As discussed below, a wide range of adverse tax consequences were identified.[10]

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[8] See Treas. Reg. § 1.1001-3(e).

[9] See ARRC, "U.S. Federal Income Tax Issues Relating to the Transition From IBORs to RFRs" (Apr. 8, 2019), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Tax-Whitepaper-April2019.pdf; SFIG, "Transition From LIBOR to Alternative Rates" (Mar. 28, 2019), available at https://structuredfinance.org/wp-content/uploads/2019/05/SFIG_letter_on_tax_impact_of_LIBOR_transition_4.23.19.pdf; The Real Estate Roundtable, Untitled letter to the U.S. Department of the Treasury (June 6, 2019), available at https://www.rer.org/docs/default-source/comment-letters/comment-letters/2019-6-6-libor-comment-ltr.pdf?sfvrsn=6562ef90_2.

[10] Notwithstanding this legal uncertainty, the Real Estate Roundtable offered theories regarding why any such amendment should not be considered a "modification" in the first instance (let alone a "significant modification") for U.S. federal income tax purposes under then-current law. Specifically, under the concept of mutual mistake of fact, "a party adversely affected by the unavailability or unreliability of LIBOR quotes might seek a judicial resolution in the nature of an interpretation of the existing LIBOR reference, or a reformation of the agreement to supply a term necessitated by a mutual mistake of fact regarding the expected continued availability of suitable LIBOR quotes." By extension, an "origin of the claim" concept might also be applied so that "a voluntary agreement to replace LIBOR with a mutually acceptable alternative could be viewed as tantamount to an out-of-court settlement of such potential litigation, and therefore could also be considered to be a continuation of the parties' original agreement and not an alteration of that agreement." See The Real Estate Roundtable, supra note 9.

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Tax Recognition for All Contracts, Including Debt and "Bullet Swaps." Gain from the disposition of an investment generally is treated as long-term capital gain (which generally is taxed to individuals at preferential rates) if, at the time of the disposition, the investment was held for more than one year. A significant modification of an investment generally causes the investment to be treated as disposed of and reissued for U.S. tax purposes. Accordingly, an amendment to an investment's reference rate could require a holder to recognize taxable gain earlier than anticipated and to be taxed at short-term capital gains rates.

COD Income for Debtors; Gain for Creditors. A significant modification of debt is treated as a retirement and reissuance of that debt. If the debt has a face amount of more than $100 million and one or more broker-dealer quotes are available for the debt, then the price at which it is deemed to have been retired generally is its fair market value at the time of the material modification. Under certain circumstances, a debtor is required to recognize cancellation of debt (COD) income if it retires its own debt for an amount that is less than the debt's principal amount. Accordingly, if, at the time of a reference rate amendment, a debt instrument trades at less than its principal amount, the debtor may have COD income. Conversely, if, at the time of a reference rate amendment, a debt instrument trades at more than its principal amount, then the creditor may have taxable gain.

Withholding on U.S. Debt Instruments. Under Code Sections 1471–1474 (commonly referred to as "FATCA"), U.S. debt instruments (and any other instruments that give rise to U.S.-source income) that were "issued" on or after July 1, 2014, and that are held by a non-U.S. person may be subject to withholding if the non-U.S. person is a foreign financial institution that fails to certify its compliance with certain information reporting requirements or is a non-financial foreign entity that fails to provide certain certifications regarding its substantial U.S. owners. A significant modification may be treated as a new issuance for this purpose. Thus, taxpayers faced the possibility that they could have been required to amend withholding and reporting systems with respect to long-dated debt instruments and potentially other instruments that, absent a reference rate amendment, might otherwise have been "grandfathered" out of FATCA.

Change in Entity Classification for Securitizations. Many mortgage-backed securitizations are structured as real estate mortgage investment conduits (REMICs) for U.S. tax purposes. Alternatively, many securitizations are structured as grantor trusts for U.S. tax purposes. REMICs and grantor trusts are limited in their ability to materially modify the debt instruments that they hold. A significant modification of these debt instruments could cause

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(1) a REMIC to lose its REMIC status and be taxed on its net income as a domestic corporation, in which case holders of certain REMIC certificates could be treated as receiving dividends (which are generally subject to 30 percent U.S. withholding tax when paid to non-U.S. persons) instead of interest (which is generally exempt from U.S. withholding tax under the "portfolio interest" exemption), and (2) a grantor trust to be treated as either (a) a "taxable mortgage pool" that is taxed on its net income as a domestic corporation, in which case holders of certain notes issued by the trust could be treated as receiving dividends (generally subject to U.S. withholding tax if paid to non-U.S. persons) instead of interest (generally exempt from U.S. withholding tax), or (b) a partnership, in which case interest earned by the entity on its assets and allocable to non-U.S. persons could become subject to 30 percent U.S. withholding tax. Accordingly, the replacement of LIBOR without accompanying tax guidance could have had disastrous consequences for the securitization industry.

Withholding on U.S. Equity-Linked Swaps and Other Derivatives. Many U.S. equity-linked derivatives provide for a LIBOR-based return to the short party. Under Code Section 871(m), certain U.S. equity-linked derivatives that were "issued" after 2020 and are held by a non-U.S. person may be subject to 30 percent withholding tax if, at issuance, they have a delta of at least 0.80 with respect to the underlying stock or certain other conditions are satisfied. A significant modification of these derivatives may be treated as a new issuance for this purpose. Thus, taxpayers had to consider the need to amend withholding and reporting systems with respect to derivatives that, absent a reference rate amendment, might otherwise have been "grandfathered" out of Code Section 871(m) withholding.

The Proposed Regulations

With so much at stake, on October 8, 2019, the Treasury and IRS issued proposed regulations confirming that transitions from LIBOR and other IBORs to alternative reference rates in debt instruments and derivatives will not be taxable events.[11] Very generally, under the proposed regulations, the modification of an instrument to replace an IBOR-based rate with a SOFR-based or other "qualified replacement rate" will not be treated as a "modification" for U.S. tax purposes, and thus will not give rise to a taxable event, if:

- The fair market value of the modified instrument is substantially equivalent to the fair market value of the unmodified instrument;[12] and

[11] See "Guidance on the Transition From Interbank Offered Rates to Other Reference Rates," REG-118784018, 84 Fed. Reg. 54,068 (Oct. 9, 2019).

[12] See Prop. Treas. Reg. § 1.1001-6(b)(2).

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- The replacement rate is based on transactions conducted in the same currency as the IBOR-based rate or is otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency as the IBOR-based rate.[13]

Qualified Replacement Rates. The proposed regulations enumerate several qualified replacement rates in addition to SOFR.[14] Qualified replacement rates also generally include:

- Rates endorsed or recommended by a central bank, reserve bank, monetary authority or similar institution as an IBOR replacement; and
- Other floating rates that can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the instrument's relevant currency.

Fair Market Value Test. A rate will not be a qualified replacement rate unless the fair market value of the modified instrument is substantially equivalent to the fair market value of the unmodified instrument (determined using a reasonable, consistently applied valuation method and taking into account the value of any one-time payment that is made in connection with the modification).[15]

The proposed regulations include two safe harbors for determining fair market value:

- *Historic Average:* The historic average safe harbor is satisfied if, on the modification date, the historic average of the replacement rate (adjusted to account for any one-time payment made in connection with the modification) is no more than 25 basis points from the historic average of the IBOR-based rate. A historic average may be determined by using an industry-wide standard or a continuous look-back of up to 10 years.[16]

- *Arm's-Length:* The arm's-length safe harbor is satisfied if the parties are unrelated and determine, based on bona fide, arm's-length negotiations, that the fair market value of the modified instrument is

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[13] See Prop. Treas. Reg. § 1.1001-6(b)(3).

[14] See Prop. Treas. Reg. § 1.1001-6(b)(1). These additional rates are based on SONIA, TONAR, SARON, CORRA, HONIA, the RBA cash rate, or €STR.

[15] See Prop. Treas. Reg. § 1.1001-6(b)(2)(i).

[16] See Prop. Treas. Reg. § 1.1001-6(b)(2)(ii)(A).

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> substantially equivalent to the fair market value of the unmodified instrument.[17]

As the phase-out of IBORs and corresponding phase-in of alternative rates could impact the fair market values of instruments that reference these rates, taxpayers may have difficulty administering the fair market value test without recourse to these safe harbors.

Contemporaneous Modifications. A modification that is associated with the designation of a qualified replacement rate and that is reasonably necessary to adopt or implement that designation is not treated as a modification for U.S. tax purposes, and therefore does not give rise to a taxable event. Examples of these modifications are (1) a change of payment dates necessitated by the use of a new reference rate or (2) the obligation of a party to make a one-time payment to the other party to offset the change in value of the instrument that would otherwise result from adopting a new reference rate.[18]

Any other modifications (for example, an increase in a debt instrument's interest rate to reflect a deterioration in the borrower's creditworthiness) must be tested separately to determine whether they give rise to a taxable event. For this purpose, the "baseline" against which such other modifications are tested is the instrument immediately after the designation of a new reference rate.[19]

One-Time Payments. The proposed regulations recognize that a modification may require a party to make a one-time payment to the other party to offset the change in value of the instrument that would result from adopting a new reference rate. Under the proposed regulations, the source and character of this one-time payment is the same as the source and character that would otherwise apply to a payment made by the payer under the instrument.[20]

This rule appears intended to treat one-time payments by borrowers as interest income that can qualify for the portfolio interest exemption from U.S. withholding tax, although it would be helpful if final regulations clarified this intent. It is unclear how a one-time payment by a lender should be treated, and the preamble to the proposed regulations requests comments on this issue. It also may not always be clear how the rule should apply with respect to derivatives, where some payments by a party may be treated as giving rise to capital gain or loss and others may be treated as ordinary income.

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[17] See Prop. Treas. Reg. § 1.1001-6(b)(2)(ii)(B).

[18] See Prop. Treas. Reg. § 1.1001-6(a)(5).

[19] See Prop. Treas. Reg. § 1.1001-6(a)(4).

[20] See Prop. Treas. Reg. § 1.1001-6(d).

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Conforming Regulatory Amendments. The proposed regulations would also make a number of other conforming changes that flow directly from the general nonrecognition rule:

- *REMICs:* A securitization vehicle will not fail to qualify as a REMIC solely because its regular interests are (1) modified to reference a qualified replacement rate in accordance with the proposed regulations, or (2) subject to a reduction of principal or interest (or similar amounts) for costs incurred to effect the modification.[21]

- *Integration, Hedging, and Grandfathering:* A modification in accordance with the proposed regulations generally will not cause a taxpayer to be treated as disposing of, or terminating a leg of, an integrated transaction or hedge, and will not cause an instrument to lose its grandfathered status under FATCA or Section 871(m).[22]

- *Contingent Payment Debt Instruments:* A floating rate debt instrument's use of a qualified replacement rate as a fallback rate will not cause that debt instrument to be treated as a contingent payment debt instrument and will not create or increase the amount of original issue discount on the instrument.[23]

Effective Date. The proposed regulations would apply to modifications that occur on or after the date that they are finalized. However, taxpayers generally may rely on the proposed regulations if they and their related parties apply them consistently.

Conclusion

The proposed regulations are intended to provide favorable rules to avoid the disruptions that could occur if replacements of LIBOR or other IBORs in debt instruments and derivatives were treated as taxable exchanges of these contracts (with the accompanying possibility of creating tax liabilities or loss of grandfather status to the relevant taxpayers to the amended financial instruments). While the proposed regulations are helpful, taxpayers still need to ensure that they satisfy certain requirements such as the fair-market-value test, which may require difficult-to-achieve proof. Further, taxpayers will need to take care that amendments initiated to replace LIBOR (or other IBORs) do not include other amendments that could trigger a taxable event.

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[21] See Prop. Treas. Reg. § 1.860G-1.

[22] See Prop. Treas. Reg. § 1.1001-6(a)(1).

[23] See Prop. Treas. Reg. § 1.1275-2(m).

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