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Federal Tax Legislative Developments

Treasury Releases Proposed Regulations on IBOR Transition

By Eschi Rahimi-Laridjani and Eileen Kuo

On October 9, 2019, the Treasury Department issued proposed regulations[1] (the "Proposed Regulations") that address the transition to reference interest rates other than interbank offered rates ("IBORs") such as the London interbank offered rate ("LIBOR") and USD LIBOR. In connection with the impending elimination of IBORs expected after the end of 2021, existing debt instruments like loans, notes, and bonds and non-debt contracts like derivatives, preferred stock and leases[2] are expected to be amended in one of three ways (each, an "Amendment"): (1) the replacement of the IBOR-referencing rate with an alternative rate, (2) the replacement of an IBOR-referencing fallback rate[3] with another fallback rate or (3) the addition of a new non-IBOR-referencing fallback rate (if none was previously provided). The primary tax concern arising from an Amendment is whether it could result in a deemed reissuance of the amended instrument for U.S. federal income tax purposes that may trigger current U.S. federal income tax liability to one or more parties to the Instrument. The Proposed Regulations also address other tax concerns raised by the IBOR transition, including with respect to whether instruments remain grandfathered under certain rules (such as Code Secs. 1471–1474[4] ("FATCA")), integrated hedges, original issue discount ("OID") in the case of variable rate debt instruments ("VRDIs"), real estate mortgage investment conduits ("REMICs") and interest expense elections of foreign corporations.

Background

Widespread scandals involving market manipulation of LIBOR have called into question the reliability of IBORs as benchmark interest rates and led to proposals to reduce their globally systemic significance by shifting to alternative reference rates. LIBOR alone has been reported to cover over $300 trillion in transactions across five currencies,[5] approximately $200 trillion of which represents exposure in USD LIBOR.[6] In response to the 2012 discovery that

LIBOR was being underreported by multiple banks,[7] the Financial Stability Board published a report in July 2014 setting forth several recommendations to reform IBORs and identify alternative benchmark rates that (1) minimize the susceptibility to market manipulation, (2) are anchored in observable transactions and (3) are robust in the face of market dislocation and command confidence that they remain resilient in times of stress.[8] Shortly thereafter, the Federal Reserve Board and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee ("ARRC") in November 2014 to identify an alternative reference rate to USD LIBOR that meets such criteria and to create a plan for implementation.[9] The ARRC is composed of various private sector market participants as well as public sector organizations (including the Securities and Exchange Commission, banking regulators, and other financial sector regulators) and is supported by the Treasury Department, the Commodity Futures Trading Commission and the Office of Financial Research. In March 2018, the ARRC published a report selecting the Secured Overnight Financing Rate ("SOFR") as the replacement for USD LIBOR.[10] In contrast with LIBOR, SOFR, which is a risk-free rate, is an overnight rate based on the cost of borrowing collateralized by U.S. Treasury securities and is based on actual observable transactions in a highly liquid U.S. Treasury repo market.[11] The ARRC has requested broad and flexible guidance from the Treasury Department and the Internal Revenue Service ("IRS") on various tax issues potentially arising from the transition away from IBOR as a predominant benchmark interest rate,[12] most of which are addressed by the Proposed Regulations.

Deemed Exchanges of Debt Instruments

The most significant tax-related concern arising from the forthcoming IBOR transition is whether related Amendments could cause a "significant modification" of a debt instrument under Reg. §1.1001-3. An Amendment that is a "significant modification" would give rise to a deemed exchange of the original debt instrument for a "new" debt instrument for U.S. federal income tax purposes.[13] Such a deemed exchange could cause an issuer to recognize cancellation of indebtedness income notwithstanding the fact that the principal amount owing remains the same, and the issuer may be treated as issuing a new debt instrument with OID for tax purposes. The deemed exchange could also be a taxable event for a holder, which could cause the holder to recognize taxable gain or loss in the year of the Amendment.

Requirements Under the Proposed Regulations

Under the Proposed Regulations, an Amendment that replaces an IBOR-referencing rate with a "Qualified Rate" (within the meaning of the Proposed Regulations) (a "Qualified Rate") will not result in a deemed exchange of a debt instrument for U.S. federal income tax purposes.[14] This rule applies to both the issuer and the holder(s) of the debt instrument.

A Qualified Rate has to be either one of eight specifically enumerated reference rates[15] or any other rate that falls within four categories: (i) rates selected by a central bank or similar institution as an IBOR replacement, (ii) any "qualified floating rate" (as defined in Treasury Regulations relating to VRDIs with certain modifications), (iii) any rate that is determined by reference to the listed rates or any rate described in clauses (i) or (ii), and (iv) any rate identified in subsequent IRS guidance.[16]

A rate will only be considered a Qualified Rate if two additional conditions are met: (1) the fair market value of the debt instrument must be substantially equivalent under the IBOR-referencing rate and the new rate (the "Substantial Equivalence Test")[17] and (2) the currency of the reference rate must remain the same (*e.g.*, USD LIBOR to SOFR) (the "Currency Continuity Test").[18] The fair market value of an instrument may be determined by any reasonable, consistently applied valuation method that takes into account the value of any one-time payment that is made in connection with the Amendment.[19] The Proposed Regulations provide two safe harbors for the Substantial Equivalence Test.

Substantial Equivalence Test Safe Harbors

First, an amended instrument can meet the Substantial Equivalence Test if the historic average of the relevant IBOR-referencing rate is within 25 basis points of the historic average of the replacement rate over a specified period, taking into account any spread adjustments and one-time payments made in connection with the Amendment (the "Historic Average Safe Harbor").[20] Historic averages can be determined by using an industry-wide standard, such as methods recommended by the International Swaps and Derivatives Association or the ARRC.[21]

Alternatively, an amended instrument can meet the Substantial Equivalence Test if (1) the parties to the instrument are unrelated and (2) through *bona fide*, arm's-length negotiations over the Amendment, the parties determine that the fair market value of the amended instrument is substantially equivalent to its fair market value prior to the Amendment (the "Arm's Length Safe Harbor").[22] The Proposed Regulations do not require any third-party certification regarding the valuation. While clearly intended as an administratively simple and taxpayer-friendly rule, it is unclear how the Arm's Length Safe Harbor would apply to many real-world transactions, such as capital markets transactions that, while arm's-length in nature, do not involve direct negotiations between issuers and holders.

Associated Alterations

The Proposed Regulations also prevent "Associated Alterations," which are changes to the terms of an instrument associated with an Amendment that are "reasonably necessary" to implement the Amendment,[23] from triggering a deemed exchange. Examples include changes to the definition of interest period or to the timing and frequency of determining rates and making payments of interest (*e.g.*, delaying payment dates on a debt instrument by two days to allow sufficient time to compute and pay interest at a Qualified Rate computed in arrears). Associated Alterations also include (1) adjustments to the spread in order to account for the expected differences between the two base reference rates and/or (2) a one-time, lump sum payment *in lieu* of a spread adjustment.[24]

Any alterations to an instrument that are not Associated Alterations (such as a change to take into account a deterioration of the issuer's credit since the issue date) will continue to be tested under the general "significant modification" rules of Reg. §1.1001-3 and will be deemed to occur immediately after the change to a "Qualified Rate."[25] Thus, other contemporaneous alterations may still trigger a taxable deemed exchange.

Deemed Exchanges of Non-Debt Contracts

Although there is no clear statutory or regulatory rule regarding the threshold for when the modification of a non-debt contract is treated as reissued for tax purposes, a similar concern exists for counterparties with respect to Amendments of non-debt contracts. The Proposed Regulations generally address this concern in the same fashion as for debt instruments. Under the Proposed Regulations, an Amendment of a non-debt contract replacing an IBOR-referencing rate with a Qualified Rate will not result in a deemed exchange of such contract under Reg. §1.1001-1(a) so long as the Amendment meets both the Substantial Equivalence Test and the Currency Continuity Test.[26] This rule and the related rules discussed above relating to debt instruments apply to each party to a non-debt contract as well as to "Associated Modifications," which are the non-debt equivalents of Associated Alterations.[27]

Source and Character of a One-Time Payment

Under the Proposed Regulations, the source and character of a one-time payment associated with a qualifying Amendment would be the same as those of a payment made by the payor with respect to the instrument that is amended.[28] The Proposed Regulations do not provide guidance on the source or character of a one-time payment from parties that do not typically make payments under an instrument, such as the holder of a debt instrument to the issuer or a lessor to a lessee, as the Treasury Department and the IRS do not expect such payments to be made in connection with the adoption of an overnight, nearly risk-free rate such as SOFR. They have, however, requested comments on this point. In addition, the Proposed Regulations leave open questions regarding the timing of income and deduction resulting from one-time payments.

Grandfathered Instruments

Certain tax statutes and regulations apply only to instruments issued after a specified date and treat any instruments issued prior to such date as "grandfathered" and thus exempt from the relevant rule. Examples include FATCA, Code Sec. 871(m) relating to "dividend equivalent payments" and the registration-required obligation rules of Code Sec. 163(f)(2)(A). An Amendment to a grandfathered instrument that triggers the reissuance of such instrument for U.S. federal income tax purposes generally would cause the instrument to become subject to a statute or regulation from which it was previously exempt.

The Proposed Regulations specifically provide that an Amendment to move to a Qualified Rate and that otherwise satisfies the tests under the Proposed Regulations would not cause an instrument to lose its grandfathered status under FATCA.[29] While the Proposed Regulations do not expressly address the rules regarding dividend equivalent payments or registration-required obligations, the preamble to the Proposed Regulations indicates that Amendments also will not cause debt instruments to lose their grandfathered status under those rules so long as the Amendment satisfies the tests under the Proposed Regulations.[30] This conclusion is entirely consistent with not treating an Amendment and Associated Alterations or Associated Modifications as resulting in a deemed exchange of the relevant instrument.

Integrated Hedges

Debt instruments and one or more hedges may under certain circumstances be treated as a single, integrated transaction for certain purposes (such as a single synthetic fixed-rate debt instrument or, in the case of a currency hedge, a synthetic debt instrument denominated in a specified currency).[31] Changes to either the debt instrument or the hedge generally can result in a "legging out" of the transaction with adverse tax consequences. The Proposed Regulations are intended to allow the debt instrument or any other component of an integrated hedge to undergo an Amendment without affecting the tax treatment of either the underlying debt instrument or the hedge, so long as the amended transaction continues to qualify for integration.[32] Given the complexities of integration and its dependence upon perfectly matched cash flows, further guidance may be warranted in this area to avoid either side of an integrated transaction from accidently "legging out" or failing to qualify for integration going forward.

OID and Qualified Floating Rates

Stated interest on a VRDI with a single "qualified floating rate" (within the meaning of Reg. §1.1275-5(b)) that meets certain other requirements may be treated as qualified stated interest for purposes of determining the amount and accrual of OID on a debt instrument.[33] Two or more qualified floating rates are treated as constituting a single qualified floating rate if such qualified floating rates can be reasonably expected to have approximately the same values throughout the term of the instrument.[34] The IBOR transition has caused concern that a VRDI with both an IBOR-referencing qualified floating rate and a non-IBOR fallback qualified floating rate would not be treated as having a single qualified rate for such purposes.

A floating rate debt instrument that fails to qualify as a VRDI or is subject to a contingency that is not remote will generally be subject to the less favorable contingent payment debt instrument rules. Under the VRDI rules, the occurrence of a remote contingency is treated as a "change in circumstances" that causes a debt instrument to be treated as redeemed and reissued for OID purposes.[35] Prior to the issuance of the Proposed Regulations, there was uncertainty whether the elimination or deterioration of IBOR would be considered remote for such purposes and, if remote, whether the occurrence of such event would cause a floating rate debt instrument with an IBOR-referencing rate to be reissued for purposes of determining OID.

The Proposed Regulations address the concern that an Amendment and/or an IBOR phase-out would prevent an instrument from qualifying for favorable VRDI treatment with the following new rules: (1) the IBOR-referencing rate and the fallback rate are treated as a single qualified floating rate for purposes of determining qualification as a VRDI,[36] (2) the possibility that IBORs will become unavailable or unreliable is treated as a remote contingency for such purposes[37] and (3) the occurrence of IBOR unavailability or unreliability is not treated as a change in circumstances that would cause the instrument to be treated as reissued.[38]

REMICs

As the terms of a REMIC regular interest are required to be fixed when issued on the startup day,[39] the impending IBOR transition raised the concern that changing the applicable interest rate on an instrument intended to qualify as a REMIC regular interest to a non-IBOR referencing rate would prevent such an interest from qualifying as a REMIC regular interest. REMIC regular interests are also required to entitle the holder to payments of interest and principal that are not contingent, subject to a list of exceptions that does not include fallback rates.[40]

The Proposed Regulations provide that a REMIC interest may be amended after the startup day and subject to certain contingencies without jeopardizing its qualification as a REMIC regular interest so long as the amendment results in a Qualified Rate and meets the Substantial Equivalence Test and the Currency Continuity Test and any contingency is related to such qualifying amendment.[41]

Interest Expense of a Foreign Corporation

Under existing Treasury Regulations, a foreign corporation that is a bank may elect to compute interest expense allocable to its excess U.S.-connected liabilities specifically using a rate referencing 30-day LIBOR rather than determining its average U.S. borrowing cost.[42] Because such alternative rate will no longer exist once LIBOR is phased out, the Proposed Regulations expand the universe of permissible rates under such an election to include a yearly average SOFR.[43]

Conclusion and Effective Date

The Proposed Regulations are intended to be taxpayer favorable and to minimize adverse tax consequences and potential market disruption from the IBOR transition. However, the application of the proposed rules in many circumstances is not entirely clear. The Treasury Department has requested comments on a number of items in the preamble to the Proposed Regulations and final regulations may differ significantly from the Proposed Regulations.

The Proposed Regulations will generally become effective on the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.[44] Nonetheless, a taxpayer may apply the Proposed Regulations before final regulations are published, so long as the Proposed Regulations are applied consistently by the taxpayer and its related parties.[45] It is not entirely clear how this interim reliance rule will work in practice and how consistency on both sides of an instrument could be ensured. In particular, it is not clear whether the obligor would control the decision or how one party could know that another party's related parties are consistently applying the Proposed Regulations.

ENDNOTES

1 Guidance on the Transition from Interbank Offered Rates to Other Reference Rates, 84 FR 54,068 (proposed Oct. 9, 2019).

2 Both debt instruments and non-debt contracts will be referred to as "Instruments" except where otherwise noted.

3 Fallback provisions specify what will occur if an IBOR is permanently discontinued or is determined to be significantly impaired as a benchmark.

4 The "Code" refers to the Internal Revenue Code of 1986, as amended.

5 Huw Jones, *Regulators Tell Derivatives Industry to Find Libor Consensus*, Reuters (Nov. 19, 2019), available at *www.reuters.com/article/us-libor-derivatives/regulators-tell-derivatives-industry-to-find-libor-consensus-idUSKBN1XT1W7*.

6 *Second Report* of *the Alternative Reference Rates Committee* (March 2018), available at *www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.com* [hereinafter *Second Report*].

7 LIBOR is based on the submissions of banks of their cost of unsecured funding.

8 Financial Stability Board, *Reforming Major Interest Rate Benchmarks* (July 22, 2014), available at *www.fsb.org/wp-content/uploads/r_140722.pdf*.

9 *Second Report*, *supra* note 6.

10 *See id.*

11 Daily volumes exceed $800M. U.S. Securities and Exchange Commission, *Staff Statement on Libor Transition* (July 12, 2019), *www.sec.gov/news/public-statement/libor-transition*.

12 *Alternative Reference Rates Committee Proposed Guidance with Respect to Libor Transition* (2019) available at *www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC_Proposed_Transition_Guidance.pdf*; David J. Kautter et al., *Re: U.S. Federal Income Tax Issue Relating to the Transition from IBORs to RFRs* (Apr. 8, 2019), available at *www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Tax-Whitepaper-April2019.pdf*.

13 Reg. §1.1001-3(b).

14 Proposed Reg. §1.1001-6(a)(1).

15 The Proposed Regulations specifically list the following rates: (i) SOFR; (ii) the Sterling Overnight Index Average (SONIA); (iii) the Tokyo Overnight Average Rate (TONAR or TONA); (iv) the Swiss Average Rate Overnight (SARON); (v) the Canadian Overnight Repo Rate Average (CORRA); (vi) the Hong Kong Dollar Overnight Index (HONIA); (vii) the interbank overnight cash rate administered by the Reserve Bank of Australia (RBA Cash Rate); and (viii) the euro short-term rate administered by the European Central Bank (EUR STR). *See* Proposed Reg. §1.1001-6(b)(1)(i)-(viii).

16 Proposed Reg. §1.1001-6(b)(1).

17 Proposed Reg. §1.1001-6(b)(2).

18 Proposed Reg. §1.1001-6(b)(3).

19 Proposed Reg. §1.1001-6(b)(2)(i).

20 Proposed Reg. §1.1001-6(b)(2)(ii)(A).

21 *Id.*

22 Proposed Reg. §1.1001-6(b)(2)(ii)(B).

23 Proposed Reg. §1.1001-6(a)(5).

24 *Id.*

25 Proposed Reg. §1.1001-6(a)(4).

26 Proposed Reg. §1.1001-6(a)(2).

27 *Id.*

28 Proposed Reg. §1.1001-6(d).

29 Proposed Reg. §1.1001-6(e).

30 *See* Preamble to the Proposed Regulations, Explanation of Provisions Section 1.D.

31 *See* Reg. §1.988-5(a) (2015); Reg. §1.1275-6(a).

32 Proposed Reg. §1.1001-6(c).

33 Reg. §1.1275-5(e)(2).

34 Reg. §1.1275-5(b)(1).

35 Reg. §1.1275-2(h)(6)(ii).

36 Proposed Reg. §1.1275-2(m)(2).

37 Proposed Reg. §1.1275-2(m)(3).

38 Proposed Reg. §1.1275-2(m)(4).

39 Code Sec. 860G(a)(1).

40 Code Sec. 860G(a)(1); Reg. §1.860G-1(b)(3).

41 Proposed Reg. §1.860G-1(e).

42 Reg. §1.882-5(d)(5)(ii)(B) (2010).

43 Proposed Reg. §1.882-5(d)(5)(ii)(B).

44 *See* Proposed Reg. §§1.1001-6(g), 1.1275-2(m)(5), 1.860G-1(e)(5)(i), and 1.882-5(f)(3).

45 *See* Code Sec. 7805(b)(7). *See also* Preamble to the Proposed Regulations, Explanation of Provisions Section 2.B.