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Treasury Department, IRS Issue Proposed Rules on Tax Impact of Transition from Libor

Douglas I. Youngman and Christopher Fiore Marotta*

The U.S. Department of the Treasury and the Internal Revenue Service have jointly issued proposed regulations to address concerns and reduce uncertainty regarding the tax impact of the anticipated discontinuation of Libor at the end of 2021. The proposed rules, which provide specific guidance and relief with respect to the transition from Libor (and other interbank offered rates) to other identified reference rates in both debt instruments and non-debt contracts, focus on specific areas where adverse tax consequences may result from amending debt instruments and other contracts to adapt to the cessation of Libor. The authors of this article explain the proposed rules, which are generally taxpayer-friendly and are intended to provide certainty and flexibility.

The U.S. Department of the Treasury and the Internal Revenue Service ("IRS") have jointly issued proposed regulations ("Proposed Regulations") to address concerns and reduce uncertainty regarding the tax impact of the anticipated discontinuation of Libor (the London Interbank Offered Rate) at the end of 2021. The Proposed Regulations modify a number of provisions of the Income Tax Regulations[1] issued under the Internal Revenue Code,[2] providing specific guidance and relief with respect to the transition from Libor (and other interbank offered rates) to other identified reference rates in both debt instruments and non-debt contracts (including derivatives). The Proposed Regulations were open for public comment until November 25, 2019.

BACKGROUND

Libor, one of the most widely used interest rate benchmarks in the world, underlies an estimated $350 trillion of outstanding contracts in maturities ranging from overnight to more than 30 years. In 2013, against a backdrop of

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[1] The Income Tax Regulations refer to the U.S. Department of the Treasury regulations promulgated under the Internal Revenue Code.

[2] The Internal Revenue Code refers to the U.S. Internal Revenue Code of 1986, as amended.

scandals regarding manipulation of Libor and decreased liquidity in interbank lending, the Financial Stability Board ("FSB"), a global body that monitors the world's financial systems, established the Official Sector Steering Group ("OSSG"), consisting of senior officials from central banks and regulatory authorities, to coordinate the review and reform of global interest rate benchmarks. In 2016, the OSSG launched a new initiative, focusing on the improvement of contract robustness to address concerns regarding discontinuation of certain key interest rate benchmarks. The OSSG invited the International Swaps and Derivatives Association Inc. ("ISDA") to lead the initiative with respect to discontinuation and fallbacks in the derivatives market.

In 2014, the Federal Reserve System and the Federal Reserve Bank of New York jointly created the Alternative Reference Rates Committee ("ARRC"), consisting of a wide variety of market participants, trade organizations and ex officio regulators. One of the ARRC's initial objectives was to identify a "risk-free alternative" rate for U.S. Dollar ("USD") Libor and to develop a plan to implement the voluntary adoption of the alternative rate. In 2017, the ARRC identified the Secured Overnight Financing Rate ("SOFR") as the replacement for USD Libor. SOFR, published daily and administered by the Federal Reserve Bank of New York, is based on more than $700 billion in overnight repurchase transactions secured by U.S. treasuries. ISDA subsequently agreed that SOFR would be the "risk-free" alternative to USD Libor for derivatives purpose as well.

In 2017, the United Kingdom's Financial Conduct Authority ("FCA"), the regulator of Libor, announced that it would no longer compel participating banks to provide submissions beyond 2021. Since that time, regulators around the world have issued continuous warnings, urging financial market participants to transition, across all product classes, to the risk-free rates in anticipation of the near-certain discontinuation of Libor. In the case of existing contracts referencing USD Libor, this would most likely require amendments to such contracts, providing specific trigger events and clear fallback provisions to ease the transition to SOFR.

Prior to the issuance of the Proposed Regulations, market participants had expressed concerns about the potential tax impact of amending the benchmark interest rates underlying debt instruments, derivatives and other non-debt contracts, as existing regulations are either ambiguous or would otherwise produce potentially adverse tax consequences. On April 8, 2019, the ARRC submitted a letter to the Treasury Department and the IRS identifying specific tax issues relating to the transition to risk-free rates in the debt and non-debt markets and requesting guidance to help ease the transition. That letter was followed, on June 5, 2019, by an additional letter from the ARRC to the

Treasury Department and the IRS, suggesting specific proposals to address the concerns raised in the April 8 letter. The Proposed Regulations have been issued in response to the ARRC's letters as well as other requests for guidance received by the Treasury Department and the IRS.

DESCRIPTION OF PROPOSED RULES

The Treasury Department and the IRS have focused on specific areas where adverse tax consequences may result from amending debt instruments and other contracts to adapt to the cessation of Libor. The Proposed Regulations are generally taxpayer-friendly rules that are intended to provide certainty and flexibility. The preamble to the Proposed Regulations specifically provides that they are being adopted to "minimize potential market disruption and facilitate an orderly transition" from Libor to alternative reference rates. From this perspective, the Proposed Regulations encourage taxpayers to act affirmatively to amend their contracts as needed to provide for replacement rates. Although the Treasury Department and the IRS state in several places that the rules are meant to be "no broader than necessary," significant latitude is generally afforded to taxpayers in amending their contracts. The Proposed Regulations are also not limited to debt instruments but rather attempt to provide guidance in all circumstances where Libor may have been used, including derivatives, insurance contracts and lease agreements. These circumstances are referred to as "non-debt contracts" in the Proposed Regulations.

Although the Proposed Regulations are not effective until their publication in final form, which may be after amendment to address comments by constituents, they may be relied on in advance of final adoption, provided taxpayers and their related parties apply them consistently.

The specific areas where the Proposed Regulations provide guidance are:

(1) Potential treatment of contract amendments as taxable exchanges of old contracts for new contracts;

(2) Impact of amendments on other contracts that may be integrated with the amended contract for U.S. federal income tax purposes;

(3) Source and character of one-time payments made by counterparties in connection with amendments;

(4) Effect of amendments on contracts otherwise exempt from certain rules due to being issued prior to their adoption;

(5) Treatment of amendments under Income Tax Regulations defining "variable rate debt instruments;"

(6) Effect of amendments and interest rate fallback provisions on "real

estate mortgage investment conduits" ("REMICs"); and

(7) Safe harbor allocations of interest expense of foreign corporations against U.S. taxable income.

NO TAXABLE EXCHANGE TREATMENT

The most far-reaching aspect of the Proposed Regulations is guidance provided on potential treatment of contract amendments as taxable exchanges. The Proposed Regulations generally provide that most contract changes, including to both debt instruments and non-debt contracts, to address pending unavailability of Libor should *not* be treated as taxable exchanges. This favorable guidance extends not only to amendments to interest rate provisions but also to all "associated" alterations and modifications to such contracts, including one-time, lump-sum payments to address the effect on value of changing the reference rate.

For amendments to fall under the favorable guidance of the Proposed Regulations, (1) they must be generally made to replace or provide a fallback to an "interbank offered rate" ("IBOR"), (2) the replacement or fallback rate must be classified as a "qualified rate," and (3) the amendment must not cause the fair market value of the contract to be substantially different. A qualified rate must be in the same currency, or be meant to approximate borrowing costs in the same currency, as the rate that is being replaced (including pursuant to a fallback provision). A qualified rate is otherwise defined by enumerated examples, which include residual categories for reference rates specified by regulatory bodies. Certain replacement rates that have already been adopted by regulatory authorities and their working groups are set forth as acceptable, including SOFR and other risk-free rates adopted in the United Kingdom, Japan, Switzerland, Australia, Canada, and Hong Kong. In addition, a qualified rate includes any other rate adopted by a central bank, reserve bank, monetary authority, or similar institution, including any committee or working group thereof, to replace an IBOR. The Treasury Department and the IRS also propose to specify additional replacement rates by publication in the *Internal Revenue Bulletin*, which would allow for further explicit safe harbors without going through the notice and comment period required for promulgation of Income Tax Regulations.

Notably, a qualified rate also includes any rate that falls under the enumerated examples but for which there is also added or subtracted a specified number of basis points, or which is subject to a multiple. However, a fixed rate does not appear to be eligible to be treated as a qualified rate. Thus, an amendment to a contract to substitute a fixed rate for Libor does not appear to fall under the favorable provisions of the Proposed Regulations.

For purposes of meeting the fair market value equivalence requirement, two safe harbors are provided, in addition to affording taxpayers general latitude to determine fair market value. As a basis for providing such flexibility, the Treasury Department and the IRS in the preamble to the Proposed Regulations acknowledge that determinations of fair market value may be difficult. Most saliently, a safe harbor is provided for unrelated counterparties that make amendments after arm's length negotiations, if the counterparties determine that such amendments do not substantially alter the fair market value of the contract, taking into account any one-time payment that is made in connection with the amendments. It may be prudent for well-advised parties to document in writing their mutual determination that the amended contract has substantially the same value as the original contract. Under a second safe harbor, if the historic averages of the two rates do not differ by more than 25 basis points, taking into account any spread, multiples and one-time payments, the amendments will also not be treated as substantially affecting fair market value. Finally, parties are further free to use any reasonable, consistently applied valuation method to determine fair market value, even if falling outside of the enumerated safe harbors.

One interesting aspect of the Proposed Regulations are their treatment of other amendments to debt instruments and non-debt contracts that occur at the same time as amendments falling under favorable guidance. Instead of taking a holistic approach to all of the changes being contemporaneously made, the Proposed Regulations still treat covered amendments as part of the original contract, such that other changes being made must be viewed against the amendments subject to non-exchange treatment instead of the original unamended contract. This may afford parties with tax planning opportunities given, for example, the treatment of rate multiples as qualified rates, subject to the requirement that covered amendments have no substantial impact on fair market value.

TREATMENT OF ONE-TIME PAYMENTS

With respect to the source and character of one-time payments made in connection with amendments to replace Libor with other rates, the Proposed Regulations provide that such payments should be treated as any other payment under the contract by the counterparty. This rule does leave some uncertainty when there are multiple kinds of payments provided for under a single contract (e.g., where a debt instrument provides for both fees and interest payments).

This rule also does not address the circumstance where the counterparty that is not the primary obligor under the contract (e.g., the lender) makes the one-time payment. The preamble to the Proposed Regulations justifies this gap

in guidance by stating that it is expected that the primary obligor will generally make the one-time payment, as risk-free rates being adopted by regulatory bodies as IBOR replacements generally suggest lower credit risk than an IBOR.

However, as provided above, a qualifying replacement rate includes any rate that increases a risk-free replacement rate by a specified number of basis points or multiple. Thus it is conceivable that in certain circumstances the counterparty that is not the primary obligor may make a one-time payment. The Treasury Department and the IRS requested comments on the proper treatment of such payments.

INTEREST DEDUCTIONS FOR FOREIGN COUNTERPARTIES

When foreign corporations with taxable U.S. business income have liabilities attributable to their U.S. businesses that are not reflected on their U.S. books and records (and are not treated as such under the Income Tax Regulations), the amount of interest on such liabilities that reduce U.S. taxable income is deemed to be based on their average U.S. borrowing costs. However, an alternative safe harbor is provided in the Income Tax Regulations based on Libor. The Proposed Regulations implement a new safe harbor based on SOFR. The new safe harbor will not be as attractive to foreign corporate taxpayers as the old safe harbor because, as stated above, SOFR is meant to approximate lower credit risk as compared to Libor, and thus should generally result in a lower reference rate. The Treasury Department and the IRS requested comments on whether an alternative rate may be more appropriate for the safe harbor.

OTHER MATTERS

The Proposed Regulations provide that amendments for replacement rates will not result in transactions integrated with such amended contracts to fail to be treated as integrated, provided that other aspects of the integration requirements continue to be met. For example, an amendment of a debt instrument or derivative to replace an interest rate referencing an IBOR with a qualified rate on one or more legs of a transaction that is subject to the hedge accounting rules will not be treated as a disposition or termination of either leg of the transaction. In addition, if a hedging transaction, which is treated as a qualified hedge for purposes of the arbitrage investment restrictions applicable to tax-exempt bonds, is modified to replace an interest rate referencing an IBOR with a qualified rate, such amendment is not treated as a termination of that qualified hedge, provided that the hedge as modified continues to meet the other requirements for a qualified hedge.

In addition, the Proposed Regulations provide clarification with respect to the application of exemptions for grandfathered obligations. Any contract

amendment that is not treated as a taxable exchange under the Proposed Regulations will also not cause the contract to cease to be subject to any grandfathering exemption from later enacted rules, including specifically Chapter 4 withholding on contracts subject to the Foreign Account Tax Compliance Act ("FATCA").

The Proposed Regulations provide certain rules that generally increase the likelihood that a debt instrument will be classified as a variable rate debt instrument, rather than a contingent payment debt instrument subject to potentially more burdensome rules. First, an IBOR-referencing qualified floating rate and a fallback rate (which will change the interest rate on the debt instrument from the IBOR-referencing rate to an alternative reference rate) will be treated as a single qualified floating rate. Second, the possibility that an IBOR reference rate will become unavailable or unreliable is treated as a remote contingency. Third, an IBOR reference rate becoming unavailable is not treated as a change in circumstance that would otherwise result in a deemed exchange. The treatment under the Proposed Regulations of an IBOR reference rate becoming unavailable is particularly interesting. Any other contingency that is classified as remote, which generally permits an instrument to be treated as a variable rate debt instrument, would result in a deemed retirement and reissuance if such a remote contingency actually occurred.

Finally, the Proposed Regulations provide several favorable rules that allow amendments to interests in REMICs to not cause adverse tax consequences. Specifically, an amendment to replace a reference rate that qualifies for non-exchange treatment is also not treated as an alteration to the terms of an interest in a REMIC, and a fallback provision to change from an IBOR if it becomes unavailable is disregarded as a contingency. In addition, any reasonable costs incurred to effect an alteration or modification that may be paid by holders of REMIC interests in connection with amendments are not treated as post-issuance contributions to a REMIC that would otherwise be subject to an additional tax.