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Deloitte Tax LLP | November 8, 2019

External Release

IRS Releases Guidance on Transition Away from LIBOR

Overview:

On October 8, 2019, the Treasury Department and the Internal Revenue Service (the "IRS") released proposed regulations (REG-118784-18) (the "Proposed Regulations") providing guidance on the tax consequences related to the transition away from the London Interbank Offered Rate ("LIBOR") and other interbank offered rates ("IBORs") to alternative reference rates in debt instruments and other financial contracts that are not debt instruments ("non-debt contracts").

Background:

On July 27, 2017, the U.K. Financial Conduct Authority (the regulator for LIBOR) announced that while it received commitments from panel banks to contribute to LIBOR through the end of 2021, markets would be unable to rely on LIBOR after such time and must transition away from LIBOR.[1] Given the prevalence of IBOR-based rates in the market and in light of concerns with respect to the transition away from such rates, central banks in the United States, the United Kingdom, Japan, Switzerland, and the Eurozone formed working groups to identify alternative reference rates in their respective currencies.

Issue:

In the United States, the Board of Governors of the Federal Reserve and the Federal Reserve Bank of New York convened the Alternative Reference Rate Committee ("ARRC") to address issues associated with the transition away from IBOR-based rates and to select an alternative reference rate to replace U.S. dollar ("USD") LIBOR. ARRC has since identified the Secured Overnight Financing Rate ("SOFR") as the preferred alternative to USD LIBOR for certain financial contracts. ARRC also identified a number of U.S. tax issues implicated in the transition away from IBOR-based rates in letters to the Treasury Department and the IRS.

Practical Considerations

As a result of this transition away from IBOR-based rates, taxpayers with debt instruments and non-debt contracts that reference an IBOR generally will need to alter or modify such instruments to: (i) replace the IBOR with a different rate or (ii) include a fallback rate in the event the IBOR becomes

available. The Proposed Regulations address many of the tax issues resulting from these alterations or modifications in a taxpayer-favorable manner. Rather than generally allowing any such alterations or modifications, however, the Proposed Regulations set forth limitations, including requiring fair market value determinations.

Proposed Regulations

The Proposed Regulations primarily address whether changes to debt instruments and non-debt contracts that alter the reference rate or include a fallback provision trigger a deemed exchange of such debt instrument or non-debt contract resulting in a realization event under section 1001. The Proposed Regulations also address a number of other tax considerations, as discussed below.

1. **Section 1001 Taxable Exchange**

   In General. Under section 1001, the sale or exchange of property generally results in the realization of the gain or loss with respect to the property.[2] With respect to exchanges of property, Treas. Reg. § 1.1001-1(a) provides that gain or loss is realized "from the exchange of property for other property differing materially either in kind or in extent."

   Treas. Reg. § 1.1001-3 governs when an alteration to a debt instrument results in the deemed retirement of the "old" debt instrument in exchange for the deemed issuance of a "new" debt instrument for U.S. federal income tax purposes. In order for such a deemed taxable exchange to occur, the regulations require that there be a modification, and also that the modification be significant.[3]

   The regulations under section 1001 provide limited guidance with respect to modifications of derivative contracts and other non-debt financial instruments.[4]

   Alterations to Debt Instruments. The Proposed Regulations provide that an alteration to the terms of a debt instrument to replace an IBOR-based reference rate with a "qualified rate" and any "associated alteration" (as defined below) are not treated as modifications for purposes of Treas. Reg. § 1.1001-3, meaning such alterations do not result in a deemed exchange of the debt instrument (subject to the fair market value requirement under the qualified rate definition, discussed below).

   Modifications to Non-Debt Contracts. Similarly, a modification to a non-debt contract to replace an IBOR-based reference rate with a qualified rate and any "associated modification" are not treated as an exchange of property for other property differing materially in kind or extent for purposes of Treas. Reg. § 1.1001-1(a), meaning such modifications do not result in a deemed exchange of the contract (subject to the fair market value requirement under the qualified rate definition).[5] Examples of non-debt contracts include derivatives, stock, insurance contracts, and lease agreements.

   Fallback Rates. Moreover, if a debt instrument or non-debt contract is altered or modified to provide for a qualified rate as a fallback rate to an IBOR-based reference

rate, such alteration or modification and any associated alteration or modification do not result in a deemed exchange of the instrument.

Associated Alteration or Modification. For the purposes of the Proposed Regulations, an associated alteration or modification refers to any alteration of a debt instrument or modification of a non-debt contract that is associated with the alteration or modification to replace the IBOR-based rate with a qualified rate, or include a qualified rate as a fallback rate, and that is "reasonably necessary" to adopt or implement that replacement or inclusion. An example of an associated alteration or modification is the addition of an obligation for one party to make a one-time payment to the other party to offset the change in value resulting from the replacement of the IBOR-based rate with a qualified rate. Thus, even if such a one-time payment would have otherwise resulted in a change in yield under Treas. Reg. § 1.1001-3(e)(2) thereby causing a deemed exchange, the Proposed Regulations provide that such one-time payment generally does not result in a deemed exchange of the debt instrument as long as the one-time payment is reasonably necessary to implement the new qualified rate and the fair market value requirement (described below) is met.

Qualified Rate. The Proposed Regulations provide a list of rates that are considered qualified rates if the rate satisfies (i) a fair market value requirement and (ii) a currency requirement. The list of qualified rates includes any alternative rate identified by the central bank, reserve bank, monetary authority, or similar institution as a replacement for an IBOR in that jurisdiction, including:

- the SOFR,
- the Sterling Overnight Index Average (SONIA),
- the Tokyo Overnight Average Rate (TONAR or TONA),
- the Swiss Average Rate Overnight (SARON),
- the Canadian Overnight Repo Rate Average (CORRA),
- the Hong Kong Dollar Overnight Index (HONIA),
- the interbank overnight cash rate administered by the Reserve Bank of Australia (RBA Cash Rate), and
- the euro short-term rate administered by the European Central Bank (€STR).

Any qualified floating rate (as defined in Treas. Reg. § 1.1275-5(b)) is also considered a qualified rate for this purpose, and the IRS may designate other rates as qualified rates in future guidance. A rate may also be a qualified rate if it is determined by adding or subtracting a specified number of basis points to or from a listed rate (*e.g.*, SOFR plus 25 bps).

Fair Market Value Requirement. The fair market value requirement provides that a rate is a qualified rate only if the fair market value of the debt instrument or non-debt contract after the alteration or modification replacing the reference rate is substantially equivalent to the fair market value of such instrument or contract before the alteration or modification, taking into account the value of any one-time

payments made in connection with the alteration or modification. For this purpose, any reasonable method for determining fair market value may be used. The Proposed Regulations set forth two fair market value safe harbors, and the IRS may publish future guidance on additional circumstances where a rate satisfies the fair market value requirement.

The first safe harbor is based on the historic average of the IBOR-based rate differing from the replacement rate by not more than 25-basis points. For this purpose, the historic average determination may be based on an industry-wide standard, such as the method for determining historic averages recommended by the International Swaps and Derivatives Association or ARRC. The historic average determination may also be determined by any reasonable method that takes into account every instance of the relevant rate published during a continuous period beginning no earlier than 10 years before the alteration or modification and ending no earlier than three months before such time.

The second safe harbor looks to whether the parties to the instrument are unrelated and determined that the fair market values of the instrument before and after the alteration or modification were substantially equivalent based on bona fide, arm's length negotiations. For this purpose, the value of any one-time payment that is made in connection with the alteration or modification must be taken into account. Because the second safe harbor applies only to third-party transactions, parties to intercompany debt instruments and intercompany non-debt contracts must rely on either the historic average of rates safe harbor or the general fair market value rule.[6]

It is worth noting that the fair market value requirement and the first safe harbor depend on the reliability of IBORs as meaningful data points in the market. IBORs are based on survey data rather than trades; as such, they derive their relevance in the market only to the extent they are referenced in financial products. Given the impending phase-out of IBORs, some market participants have already started offering financial products in the market based on alternative rates such as SOFR – a trend that is likely to accelerate. Therefore, there is a likelihood that IBORs (or certain aspects of them) may become unreliable prior to their official phase-outs, which may result in some challenges or uncertainty around being able to satisfy the requirements under the Proposed Regulations.

Currency Requirement. The currency requirement generally provides that the replacement reference rate must be based on transactions conducted in the same currency as the original IBOR-based reference rate or otherwise must be reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency (*e.g.*, a EUR-based rate should be replaced with a EUR-based rate).

Contemporaneous Alterations and Modifications. If along with alterations or modifications described above, the parties make other alterations or modifications to an instrument (*e.g.*, the extension of the maturity date), such

other changes must be analyzed separately under Treas. Reg. §§ 1.1001-3 and 1.1001-1(a) to determine whether they result in a deemed exchange of the instrument. When applying Treas. Reg. §§ 1.1001-3 and 1.1001-1(a) for this purpose, the altered or modified terms described above (*i.e.*, to replace the IBOR-based reference rate with a qualified rate or include a fallback rate) are treated as part of the terms of the instrument prior to any other alteration or modification.

2. **Other Considerations**

Integrated Transactions and Hedges. The Proposed Regulations address concerns with integrated transactions by providing that an alteration or modification to a debt instrument or derivative to replace the IBOR-based reference rate with a qualified rate on one or more legs of a transaction that is integrated under Treas. Reg. §§ 1.988-5 or 1.1275-6 is not treated as legging out of the transaction, provided that the hedge as modified continues to meet the relevant requirements under Treas. Reg. §§ 1.988-5 or 1.1275-6, as applicable. The Proposed Regulations similarly provide that an alteration or modification to a debt instrument or derivative to replace an IBOR-based interest rate with a qualified rate on one or more legs of a transaction subject to the hedge accounting rules in Treas. Reg. § 1.446-4 will not be treated as a disposition or termination of either leg of the transaction.[7]

Source and Character of One-Time Payments. The Proposed Regulations provide that a one-time payment that is made in connection with an alteration or modification to replace an IBOR-based rate or include a fallback rate will have the same source and character that would have otherwise applied to a payment made by the payor with respect to the debt instrument or non-debt contract at issue. The Proposed Regulations do not provide any further guidance on the source and character of one-time payments and do not provide any guidance on the timing for recognizing such payments. Thus, the limited guidance currently available remains the only guidance with respect to the source, character and timing of such payments.

Debt Tax Accounting Rules. The Proposed Regulations address concerns raised regarding the application of the debt tax accounting rules and the potential for the change in reference rate to result in a debt instrument no longer qualifying under the variable rate debt instrument ("VRDI") rules in Treas. Reg. § 1.1275-5. Under the Proposed Regulations, if a debt instrument with a qualified floating rate for VRDI purposes that references an IBOR-based rate provides for a different reference rate in the event that the IBOR-based rate is no longer available, the IBOR-rate and the different rate will be treated as a single qualified floating rate for purposes of the VRDI rules. Moreover, for purposes of the OID regulations in Treas. Reg. § 1.1275-2, the possibility that the IBOR-based rate will become unavailable is treated as a remote contingency and the fact that the IBOR-based rate becomes unavailable is not treated as a change in circumstances. Thus, under the Proposed Regulations, IBOR-based debt instruments that provide for fallback rates generally should be treated as VRDIs rather than being subject to the contingent payment

debt instrument rules simply because of the potential for the change in reference rate.

REMIC Regular Interests. In order to mitigate potential issues with REMIC regular interests that reference IBORs no longer qualifying as REMIC regular interests because of a change in the reference rate, the Proposed Regulations provide that an alteration to a REMIC regular interest occurring after the startup day to change the rate to a qualified rate or include a fallback rate is disregarded when determining whether the REMIC regular interest has fixed terms on the startup day. Further, a REMIC interest does not fail to qualify as a regular interest solely because it is subject to a contingency whereby the IBOR-based reference rate may change to a different rate permitted under the REMIC rules if the IBOR-based rate becomes unavailable.

Treas. Reg. § 1.882-5(d)(5)(ii)(B) Election. Certain foreign banks may make a simplifying election to use 30- day LIBOR for computing excess interest under Treas. Reg. § 1.882-5(d)(5)(ii)(B). The Proposed Regulation would replace the reference to 30-day LIBOR in the regulation with the yearly average SOFR for the taxable year.

Applicability Dates and Reliance on the Proposed Regulations

The Proposed Regulations generally apply to alterations or modifications occurring on or after the date the final regulations are published in the Federal Register. Taxpayers and their related parties may, however, apply the Proposed Regulations to alterations and modifications occurring before the date the final regulations are published in the Federal Register, provided that they consistently apply the rules before such date.

Contact:

Please contact one of the professionals listed below if you have any questions or would like additional information on the topics covered in this alert.

For financial instruments questions, please contact Craig Gibian or Mary Jo Lang.

For foreign currency questions, please contact Michael Mou or Aziza Yuldasheva.

For transfer pricing questions, please contact Ariel Krinshpun.

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[1] A transcript of the speech on the future of LIBOR that was delivered by Andrew Bailey, Chief Executive of the U.K. Financial Conduct Authority, is available at the following link: https://www.fca.org.uk/news/speeches/the-future-of-libor.

[2] Section 1001(c). In the case of a debt instrument that is subject to a deemed exchange under section 1001, the borrower generally realizes any cancellation of indebtedness income or repurchase premium.

[3] Treas. Reg. § 1.1001-3(b).

[4] *See* Treas. Reg. § 1.1001-4 (providing that, from the perspective of the nonassigning party, a counterparty's transfer or assignment of a derivative contract does not result in the deemed exchange of the original contract for a modified contract differing materially in kind or extent if certain conditions are true).

[5] The Proposed Regulations also clarify that any such modification to a non-debt contract is not a material modification for purposes of the FATCA grandfathering rule in Treas. Reg. § 1.1471-2(b)(2)(iv). In general, any modification or alteration that does not result in a deemed exchange of the debt instrument or non-debt contract should not result in the debt instrument or non-debt contract losing grandfathered status under a tax regime such as FATCA, section 871(m) or Treas. Reg. § 1.385-3.

[6] The definition of "related parties" in the second safe harbor refers to section 267(b) and section 707(b)(1). Those sections generally refer to corporations and partnerships where there is more than 50 percent ownership, which is a different standard than the term "controlled" under Treas. Reg. § 1.482-1(i)(4). Because of the different standards, the second safe harbor may be available in situations where section 482 is generally applicable.

[7] The Proposed Regulations also address the replacement of an IBOR-based interest rate on a hedging transaction for bonds that are integrated as qualified hedges under Treas. Reg. § 1.148-4(h) for purposes of the arbitrage investment restrictions on certain tax-exempt bonds by providing that such a modification is not treated as a termination of the qualified hedge, provided that the hedge as modified continues to meet the relevant requirements under Treas. Reg. § 1.148-4(h).

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