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IBOR Transition: Current Status of US Federal Tax Guidance

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Thomas Humphreys | Partner, Mayer Brown
Brennan Young | Associate, Mayer Brown

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Agenda

- Background
- The (Main) Tax Concern
- The Proposed Regulations
- Rev. Proc. 2020-44
- Putting it Together

Background

- Anticipated that LIBOR will cease to be published at the end of 2021
- Fallback mechanics are being included in documentation
- As usual – US federal tax considerations follow
- In April 2019, the ARRC (and others) requested guidance from the US Treasury on the US federal tax consequences of replacing LIBOR
- In October 2019, the IRS released proposed regulations addressing IBOR replacement
- In October 2020, the IRS released Rev. Proc. 2020-44 with limited guidance for amending existing instruments

The (Main) Tax Concern

Potential Deemed Exchange

- Does the change to an instrument's floating interest rate result in a "significant modification" under Treas. Reg. § 1.1001-3?
  - Concern exists for actual replacement of an IBOR pursuant to fallback provisions and the addition of IBOR fallbacks to an existing instrument
- If there is a "significant modification," potential deemed exchange

Significant Modification

- Is there a "modification" ?
- Exceptions
  - Alterations pursuant to the terms of a debt instrument
  - Unilateral option of issuer or holder

Significant Modification (cont'd)

- Is the modification "significant" ?
- Multiple tests, but change in yield test most likely for alterations to floating interest rate
  - Change in yield - does annual yield on "new" instrument differ from yield on "old" instrument by more than the greater of (a) .25% or (b) 5% of the annual yield of the "old" instrument
- General facts and circumstances test

Consequences of Significant Modification

- Deemed exchange of the “old” note for the “new” note
- Potential for recognition of gain or loss to US holders
  - Gain (and potentially loss) equal to difference between issue price of the “new notes” and holder’s adjusted tax basis
    - Issue price may be principal amount or FMV, depending on whether notes are treated as traded on an established market
  - Possible recapitalization for corporate debt
- Potential for original issue discount (“OID”)
- Cancellation of indebtedness income for the issuer

The Proposed Regulations

What is Covered?

- Under Prop. Treas. Reg. § 1.1001-6, if terms of debt instrument are modified to:
  - replace an IBOR rate with a "qualified rate"
  - to provide for a fallback for an IBOR rate with a "qualified rate"
  - to substitute a "qualified rate" in place of a rate referencing an IBOR rate as a fallback to another rate
- And those modifications meet the requirements of the proposed regulations, then those modifications (and certain associated alterations and modifications) are not treated as modifications under Treas. Reg. § 1.1001-3
- Effective once published as final, but taxpayers can rely on the regulations if applied consistently

“Qualified Rate“

- Two requirements:
  - Rate must be one of the enumerated qualifying rates
  - FMV of the instrument after the modification or alteration must be “substantially equivalent” to the fair market value of the instrument before the modification or alteration

Qualifying Rates

- List is broad, including:
  - SOFR based rates, SONIA based rates, among certain other similar rates
  - Any alternative, substitute, or successor rate selected, endorsed or recommended by the central bank, reserve bank, or monetary authority or similar institution (including any committee or working group thereof)
  - Any “qualified floating rate,” as defined in Treas. Reg. § 1.1275-5(b)
  - Any rate determined by reference to the above rates
  - Other rates the IRS may identify

Qualifying Rates (cont'd)

- "Qualified floating rate," as defined in Treas. Reg. § 1.1275-5(b)
  - a rate is a QFR if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which a debt instrument is denominated
- What about the fan favorites?
  - Compounded SOFR
  - Term SOFR
  - Newcomer BSBY

Substantially Equivalent FMV

- In general, the fair market value of the instrument after the modification or alteration must be substantially equivalent to the fair market value of the instrument before the modification or alteration
- The proposed regulations include two safe harbors:
  - Historic average safe harbor
  - Arm’s length safe harbor

Substantially Equivalent FMV (cont'd)

- The preamble to the proposed regulations states that the substantial equivalence requirement is intended to "broadly facilitate the transition away from IBORs"
- Under the general rule, a rate is a qualified rate only if the FMV of the debt instrument after the alteration or modification is substantially equivalent to the FMV of the debt instrument before the alteration or modification
  - In making the FMV determination, the parties may use any reasonable, consistently applied valuation method
- Concerns:
  - To whom and how is a "consistently applied method" evaluated?
  - What is the "substantially equivalent" standard under the general test? Within 25 bps? 10 bps? 100 bps?

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Substantially Equivalent FMV (cont'd)

- Historic average safe harbor
  - historic average of the relevant IBOR rate does not differ by more than 25 basis points from the historic average of the replacement rate, taking into account any spread or other adjustment to the rate, and adjusted to take into account any one-time payment that is made in connection with the alteration or modification
- Concern: how can we know today whether when an IBOR is replaced, the test will be met?

Substantially Equivalent FMV (cont'd)

- Arm's length safe harbor
  - Parties to the instrument are not related, and
  - The parties determine, based on bona fide arm's length negotiations between them, that the FMV of the instrument after the modification or alteration is substantially equivalent to the FMV of the instrument before the change
- Concerns:
  - Can the indenture trustee negotiate on behalf of the holders?
  - How do the parties substantiate their "determination" of the substantially equivalent FMV?

Feedback to the IRS (and IRS Response?)

- Multiple comment letters were sent to the IRS, including from:
  - Structured Finance Association
  - New York State Bar Association
  - National Association of Bond Lawyers
  - Mortgage Bankers Association
  - Institute of International Bankers (and more)

Rev. Proc. 2020-44

Rev. Proc. 2020-44

- Released on October 9, 2020
- Separate from the proposed regulations
- Provides retroactive but limited relief for amending specific types of legacy contracts to add fallback mechanics for LIBOR or other IBORs to include ARRC fallbacks or ISDA fallbacks

Rev. Proc. 2020-44 (cont'd)

- Added fallbacks must generally strictly follow ARRC recommendation or ISDA language
- Certain deviations permitted, including those "to add, to revise, or to remove technical, administrative, or operational terms, provided that the addition, revision, or removal is reasonably necessary to adopt or to implement the ARRC fallback or the ISDA fallback"
  - E.g., changes to interest period, the timing and frequency of determining rates, and the timing and frequency of making payments of interest


Putting it Together

Example 1: The Old Ways

- Lender and Borrower have an outstanding debt instrument issued in 2015 that pays floating rate interest annually based on three month LIBOR plus a spread
- Lender has the right pursuant to the loan agreement to select a replacement if three month LIBOR is discontinued
- Borrower has no consent right to the rate change

Example 2: Applying the Proposed Regulations

- Lender and Borrower have an outstanding debt instrument issued in 2015 that pays floating rate interest annually based on three month LIBOR plus a spread
- Lender has the right pursuant to the loan agreement to select a replacement if three month LIBOR is discontinued
- Borrower has a consent right to the rate change

Example 3: Applying the Rev. Proc.

- Lender and Borrower have an outstanding debt instrument issued in 2015 that pays floating rate interest annually based on three month LIBOR plus a spread
- The instrument provides no fallback rate for three month LIBOR
- Lender and Borrower agree to amend the instrument to provide a fallback to three month LIBOR with ARRC recommended fallbacks

Additional Resources and Supplemental Materials

Visit our blog, Eye on IBOR Transition,

for recent news and updates you may

find helpful.

Read more:

- New Rev Proc 2020-44 Provides Limited Relief for Amending Legacy Contracts to Add IBOR Fallbacks
- The World's Most Important Number: The IRS Addresses the Replacement of LIBOR

Contacting the Speakers

Thomas A. Humphreys

Partner

thumphreys@mayerbrown.com

New York

T +1 212 506 2450

Brennan W. Young

Associate

byoung@mayerbrown.com

New York

T +1 212 506 2691

Americas | Asia | Europe | Middle East

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