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Overview of Final Tax Regulations for IBOR Transition

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Agenda

- Background
- The (Main) Tax Concern
- The Before Times - Proposed Regulations and Rev. Proc. 2020-44
- The Final Regulations
- Effective Dates
- Putting It Together

Background

- Anticipated that LIBOR will cease to be published in June 2023
- 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
- On December 30, 2021, the IRS released **final regulations** making some helpful changes

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

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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

Non-debt Contracts

- There are no clearly defined rules for amending non-debt contracts
- Cottage Savings Association v. Commissioner, 499 U.S. 554, could be read to imply a "hair trigger" based on "legally distinct entitlements" standard

The Before Times – The Proposed Regulations and Rev. Proc. 2020-44

The Proposed Regulations

- Under Prop. Treas. Reg. § 1.1001-6, if terms of debt instrument were 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 met the requirements of the proposed regulations, then those modifications (and certain associated alterations and modifications) were not treated as modifications under Treas. Reg. § 1.1001-3

The Proposed Regulations *(cont'd)*

- Two requirements to be a "qualified rate":
  1. Rate must be one of the enumerated qualifying rates
  2. 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

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:
    1. Historic average safe harbor
    2. Arm's length safe harbor

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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
- The final regulations make the Rev. Proc. permanent

The Final Regulations

Overview

- The fair market value equivalence standard is no more
- Through a "waterfall" of definitions, the final regulations contain a simple structure that blesses any modification to a contract that is a "covered modification," ***unless*** a portion of the modification is a "noncovered modifications"
  - Applicable to all our favorites, including debt, stock, derivatives, insurance contracts, and leases
- The final regulations make clear the test applies both when a fallback is added and when/if the fallback is implemented
- Guidance for specific situations, instruments and taxpayers also included

What is a Covered Modification?

- If terms of an instrument are modified to:
  - replace a "discontinued IBOR" rate with a "qualified rate" and any a "qualified one-time payment" made in connection with the replacement
  - to provide for a fallback for a "discontinued IBOR" rate with a "qualified rate"
  - to substitute a "qualified rate" in place of a rate referencing a "discontinued IBOR" rate in an existing fallback
- Also blessed are any "associated modifications" in connection with the above
  - **Question: Do the regulations apply to an instrument already based on SOFR?**

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What is a Covered Modification? - Defined Terms

- A “discontinued IBOR” is generally an interbank offered rate that has had the applicable administrator announce a plan to cease its publication (with no successor administrator taking over), and is not more than one-year after the actual cessation of publication.
- A “qualified rate” is basically any rate that measures contemporaneous variations in the cost of newly borrowed funds as long as it is based in the same currency as the rate in the existing contract (including adding or subtracting a specified number of basis points to or from any such rate, or by multiplying any such rate by a specified number).
  - Also included are is any rate referencing these rates in its formulation
  - **Question: What is an example of something besides SOFR we are seeing that fits this definition?**

What is a Covered Modification? - Defined Terms *(cont'd)*

- "Associated modification" includes the modification of any technical, administrative, or operational terms of a contract that is reasonably necessary to adopt or to implement an IBOR replacement modification. In addition, these include any incidental cash payment intended to compensate a counterparty for small valuation differences resulting from a modification to the administrative terms of a contract

- "Qualified one-time payment" is a single cash payment that is intended to compensate the other party or parties for all or part of the basis difference between the discontinued IBOR and the interest rate benchmark to which the qualified rate refers

Noncovered Modifications

- “Noncovered modifications” - the terms of the contract are modified to change the amount or timing of contractual cash flows and that change is:
  - intended to induce one or more parties to perform any act necessary to consent to the modification to the contract,
  - intended to compensate one or more parties for a modification to the contract not related to IBOR replacement,
  - either a concession granted to a party to the contract because that party is experiencing financial difficulty or a concession secured by a party to the contract to account for the credit deterioration of another party to the contract, or
  - intended to compensate one or more parties for a change in rights or obligations that are not derived from the contract being modified
- Noncovered modifications are tested under the prior law for a deemed taxable exchange, and not provided the special dispensation under these Final Regulations

Noncovered Modifications *(cont'd)*

- Regulatory example of a "noncovered modification" –
  - Issuer's debt instrument pays interest semiannually at a rate of six-month USD LIBOR plus 100 basis points. Lender and Issuer modify the debt instrument to replace that original rate with six-month CME Term SOFR plus an adjustment spread of 42.826 basis points plus 100 basis points. Lender and Issuer chose the adjustment spread of 42.826 basis points because that is the adjustment spread used or recommended by the International Swaps and Derivatives Association and the Alternative Reference Rates Committee for similar substitutions or replacements of six-month USD LIBOR with a tenor-adjusted variant of SOFR. At the same time as and for reasons unrelated to the LIBOR replacement modification, Lender and Issuer also modify customary financial covenants in the debt instrument in a manner that benefits Issuer. In exchange for this modification, Issuer agrees to add 30 basis points to the rate such that, once all modifications are effective, the debt instrument pays interest at a rate of six-month CME Term SOFR plus 172.826 basis points.
  - The portion of these modifications that implements the LIBOR replacement modification with basis adjustment spread is a "covered modification". The portion of these modifications that modifies customary financial covenants is a "noncovered modification", and the portion of these modifications that adds 30 basis points to the rate changes the amount of cash flows on the debt instrument, and the parties intend that change to compensate Lender for a modification to the debt instrument that is not for IBOR rate replacement. Therefore, the portion of these modifications that adds those 30 basis points to the rate, is a noncovered modification of the debt instrument.

Testing Fallback Rates as Covered Modifications

- The final regulations clarify that if an existing contract is modified to adopt IBOR fallbacks, the testing for whether there has been a taxable exchange excepted by the regulations must be done **both** when the fallback mechanics are adopted and when the fallback rate is implemented, if ever
  - If upon implementation of a fallback rate under the contract, that modification is not a "covered modification" under the Final Regulations, taxpayers are left with standards under prior law (*e.g.*, in the case of a debt instrument, the tests under Treas. Reg. 1.1001-3 for determining whether a modification is a "significant modification")

Testing Fallback Rates as Covered Modifications

(cont'd)

- Each rate in the waterfall must generally be a qualified rate
- Indeterminable rates are not qualified
- Exception for rates with a remote likelihood

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Tax Consequences

- For a qualifying modification, *i.e.*, a “covered modification,” the regulations provide the result that the modification is not treated as a deemed taxable exchange of the contract under Treas. Reg. section 1.1001-1(a)

Tax Consequences - Hedging

- For covered modifications on financial instruments like hedges and integrated transactions, a covered modification is not treated as legging out of or terminating the transaction only 90 days unless the integrated or hedging transaction satisfies the requirements of the applicable regulations within 90 days of the first covered modification of such transaction
- “Super integrated” hedging of tax-exempt bonds are not covered

Tax Consequences - Trusts

- New from the proposed regulations
- An investment trust is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders
- The final regulations provide that neither a covered modification of a contract held by an investment trust nor a covered modification of an ownership interest in the investment trust are treated as a power to vary the investment of the certificate holder for purposes of Treas. Reg. section 301.7701-4(c)(1)

Tax Consequences - REMICs

- A change in the reference rate for a regular interest after the REMIC startup day that is a covered modification is disregarded in determining whether the regular interest has fixed terms on the REMIC startup day
- A REMIC does not fail to qualify as a regular interest solely because it is subject to a contingency whereby a rate that references a discontinued IBOR and is a variable rate permitted by the REMIC rules may change to a fixed or different variable rate also permitted under the REMIC rules in anticipation of an IBOR becoming unavailable or unreliable
- An interest in a REMIC does not fail to qualify as a regular interest solely because it is subject to a contingency whereby the amount of payments of principal or interest with respect to the REMIC interest are reduced by reasonable costs (now informally including costs for tax opinions and rating agency confirmations) incurred to replace a discontinued IBOR

Tax Consequences – VRDI Rules

- Similar to the proposed regulations, relief for a tax advisor's stress:
  - Fallbacks count as a single rate
  - An IBOR becoming unavailable treated as a remote contingency

Tax Consequences – Other

- Fast-pay stock: fairly specific relief for a relatively unusual circumstance
  - Retested when there is a change in circumstance, which is covered modification is not

- FATCA: a covered modification does not spoil grandfathered status

Open Items

- Character and sourcing – to be the subject of additional regulations
- The final regulations leave room for the addition of more qualified rates and noncovered modifications
- Section 882 interest expense allocation for foreign banks

Effective Dates

Effective Dates – Past and Present

- The Final Regulations become effective 60 days after they are published in the Federal Register.
- A taxpayer may rely on the Final Regulations before such date, provided that the taxpayer and parties related to the taxpayer apply the regulations consistently.
- For IBOR replacement amendments entered into after the Proposed Regulations were issued but before the date the Final Regulations were issued, taxpayers are permitted to rely on the Proposed Regulations
- As discussed, the Rev. Proc. remains usable guidance

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 v. Final 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
- The parties modify the instrument to add a SOFR based rate as a fallback on June 1, 2020
- How about if the parties modified on June 1, 2022?

Additional Resources and Supplemental Materials

Visit our blog, Eye on IBOR Transition, for recent news and updates you may find helpful.

Eye on IBOR Transition

December 2021 Is In Sight

SCAN HERE WITH YOUR PHONE'S CAMERA TO VISIT AND SUBSCRIBE FOR UPDATES!

Read more:

- US IRS Releases Final Regulations Addressing IBOR Transition
- New Rev Proc 2020-44 Provides Limited Relief for Amending Legacy Contracts to Add IBOR Fallbacks

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