

Legal Update

The World's Most Important Number: The IRS Addresses the Replacement of LIBOR

The London Interbank Offer Rate ("LIBOR") was considered the most banal reference point in modern finance until 2012 when it was discovered that the rate was unreliable. And when \$350 trillion of securities use the same index to determine payments, even the smallest tweak can (and did) result in extreme discontinuities in the financial markets. LIBOR has been so engrained in the world-wide financial system that notwithstanding these challenges, financial regulators will not discontinue publishing LIBOR until 2022. The resulting change in the reference rate on bonds and derivatives could have substantial unanticipated US federal income tax consequences.

On October 8, 2019, the US Internal Revenue Service (the "IRS") released proposed regulations (the "Proposed Regulations") addressing certain US federal tax consequences of replacing an interbank offered rate with a successor rate.¹ As discussed in more detail below, the Proposed Regulations generally provide (a) circumstances in which the replacement of an IBOR, such as LIBOR, with a fallback rate, or an addition of a fallback mechanic to an existing instrument, will not result in a deemed taxable exchange of the instrument under section 1001 of the Internal Revenue Code of 1986, as amended (the "Code"), (b) the source and character of any one-time payment associated with a replacement of an IBOR rate, (c) relief under the

Key Takeaway

Under the Proposed Regulations, replacement of an IBOR (or the addition to an instrument of a fallback mechanic to replace an IBOR) will generally not result in a deemed exchange for US federal income tax purposes if:

- 1) the fallback rate is a qualifying rate (which is broadly defined), and
- 2) the fair market value of the instrument after the replacement or addition is substantially equivalent to the fair market value of the instrument before the replacement or addition.

rules for real estate mortgage investment conduits ("REMICs"), and (d) some relief pursuant to specific tests under existing regulations governing variable rate debt instruments ("VRDIs").

Background

As noted above, LIBOR is slated to cease to be supported at the end of 2021. In response, many issuers are now including fallback provisions in their instruments designed to provide mechanics for replacing LIBOR when that day comes. Of particular relevance to LIBOR specifically, the Board of Governors of the Federal Reserve System and the

Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (the "ARRC"). ARRC has proposed a fallback "waterfall" for various types of newly issued, dollar-denominated LIBOR debt instruments.² These fallbacks have not yet gained sufficient adherence to be considered standard across the market, but their incidence is increasing. One of these rates, the Secured Overnight Financing Rate ("SOFR"), measures the cost of overnight borrowings through repo transactions collateralized with US Treasury securities. Unlike LIBOR, it is always based on actual transactions.

IBOR Replacements Under Section 1001

THE CONCERN

For debt instruments and other financial instruments, a main US federal income tax concern surrounding the replacement of an IBOR rate on an outstanding financial instrument is whether the replacement (or addition to include a fallback mechanic) results in a "significant modification." If the replacement or addition is a significant modification, holders of the debt instrument would have a deemed (potentially taxable) exchange of their "old" note for a "new" note. This deemed exchange could result in current gain recognition to a holder or counterparty.

An alteration of a legal right or obligation that occurs pursuant to the terms of a debt instrument is not a "modification." In addition, issuer and holder options that can be unilaterally exercised are generally not modifications (provided, in the case of a holder option that the exercise does not result in a deferral of, or reduction in, any scheduled payment of principal or interest). An option is unilateral only if, under the debt's terms or applicable law (i) there does not exist, at the time of exercise or as a result of exercise, a right in the other party to alter or terminate the debt instrument or to put the instrument to a person related (using a more than 50 percent standard) to the issuer, (ii) the exercise of the option does not

require the consent of the other party, a related party or a court, and (iii) the exercise of the option does not require consideration unless on the debt instrument's issue date the consideration is a *de minimis* amount, a specified amount or based on a formula that uses objective financial information.

There are multiple tests for determining whether a modification is "significant," including a test measuring whether there has been a change in yield, which generally asks whether the annual yield on the "new" instrument differs from the annual yield of the "old" instrument by no more than the greater of 0.25 percent or 5 percent of the annual yield of the old instrument.

There is a similar concern for non-debt instruments, but there are no clearly defined tax rules for when a deemed exchange occurs on such instruments.

Without specific guidance on the replacement of an IBOR rate, in order to avoid a deemed exchange, parties were left with these imperfect exceptions which invariably create uncertainty in many circumstances.

THE APPROACH OF THE PROPOSED REGULATIONS

The IRS intends to provide a broad exemption when replacing an IBOR rate with a successor index. The Proposed Regulations provide for the circumstances in which the replacement of an IBOR rate by a "qualified rate," the alteration of terms of an instrument to add a fallback "qualified rate" for an IBOR rate, or the replacement of an IBOR rate that is itself a fallback, will not constitute a modification, and therefore will not result in a deemed (potentially taxable) exchange.

For debt instruments, the Proposed Regulations provide that if the terms of a debt instrument are modified (1) to replace an IBOR rate with a "qualified rate," (2) to provide for a fallback for an IBOR rate with a "qualified rate," or (3) to substitute a "qualified rate" in place of a rate referencing an IBOR rate as a fallback to another rate, those modifications (and certain associated alterations and modifications with respect to that modification)

are not treated as modifications and, therefore, do not result in a significant modification. The Proposed Regulations contain a similar rule for non-debt contracts, including swaps and forwards.

The Proposed Regulations define “associated alteration or modification” as any alteration of an instrument that is associated with the alteration or modification by which a qualified rate replaces, or is included as a fallback to, the IBOR rate that is reasonably necessary to adopt or implement that replacement or inclusion. For example, technical, administrative, or operational alterations or modifications, such as a change to the definition of an interest period or a change to the timing and frequency of determining rates or making payments of interest, are intended to be covered by this definition.

The associated alteration or modification rule allows the parties to account for any anticipated difference between the expected yield of the IBOR rate and the expected yield of the replacement rate with a one-time payment without triggering a modification. The Preamble to the Proposed Regulations noted that industry groups, in particular the ARRC, had requested guidance on the source, timing of recognition of income, and withholding tax consequences of a one-time compensating payment. The Proposed Regulations treat compensating payments in the same manner as other payments under the instrument.³ Thus, with respect to debt instruments, this treatment would mean that a compensating yield payment would be treated as interest if made by the issuer and an offset to interest if made by the holder of the debt instrument. We explore these issues in detail below.

For a replacement or fallback rate to be a “qualified rate,” (1) the rate must fall within one of the enumerated categories of rates that can be qualified rates (a “Qualifying Rate”), and (2) 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 “Substantial Equivalence Requirement”).

In implementing the requirement that a replacement or fallback rate constitutes a Qualifying Rate, the IRS was as broad as could have been reasonably hoped. The Proposed Regulations list the following rates as Qualifying Rates:⁴

- 1) SOFR, which is published by the Federal Reserve and is the base component of the fallback options championed by the ARRC, the Sterling Overnight Index Average, the Tokyo Overnight Average Rate, the Swiss Average Rate Overnight, the Canadian Overnight Repo Rate Average, the Hong Kong Dollar Overnight Index, the interbank overnight cash rate administered by the Reserve Bank of Australia, and the euro short-term rate administered by the European Central Bank;
- 2) Any alternative, substitute or successor rate selected, endorsed or recommended by the central bank, reserve bank, monetary authority or similar institution (including any committee or working group thereof) as a replacement for an IBOR or its local currency equivalent in that jurisdiction;
- 3) Any qualified floating rate (a “QFR”), as defined in Treas. Reg. § 1.1275-5(b) (without regard to the limitations on multiples contained in that regulation) that is not described in (1) or (2) above;
- 4) Any rate that is determined by reference to a rate described in (1)-(3) above, including rates determined by adding or subtracting a specified number of basis points to or from the rate or by multiplying the rate by a specified number; and
- 5) Any rate identified as a Qualifying Rate in subsequent IRS guidance.

There are two points worth emphasizing about this list of Qualifying Rates. First, the inclusion of any QFR as a Qualifying Rate demonstrates the IRS intent to define “qualified rate” broadly. Under the relevant regulations, 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.⁵ Thus, while at first

glance one might not see their preferred replacement rate on the list, as long as the rate meets this definition, that rate is a Qualifying Rate within the meaning of the Proposed Regulations. Second, by including (4) above, the Proposed Regulations bless the SOFR-based rates backed by the ARRC, term SOFR and compounded SOFR.

The Substantial Equivalence Requirement is where the Proposed Regulations may present challenges in practice. As noted, under this requirement, 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.⁶ In determining fair market value for this purpose, the parties to an instrument can use any reasonable, consistently applied valuation method and must take into account the value of any one-time payment that is made in connection with the alteration or modification. A reasonable valuation method may, but does not have to, be based in whole or in part on past or projected values of the relevant rate. The Proposed Regulations provide two safe harbors for the Substantial Equivalence Requirement.

First, a modification or alteration satisfies the Substantial Equivalence Requirement if the 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.⁷ The concern with this safe harbor stems from a situation in which an instrument includes a fallback waterfall for its IBOR rate. One cannot be sure today whether at the end of 2021 a replacement rate will satisfy this historical averaging test. For example, while SOFR (which looks at a single overnight rate) has historically been relatively close to overnight LIBOR, the rate exploded to be more than two times higher than overnight LIBOR for a day in September.⁸ Thus, there is a risk that market participants may not have absolute certainty that they will be able to rely on this safe harbor in

structuring their IBOR rate fallback mechanics today.⁹

Second, a modification or alteration satisfies the Substantial Equivalence Requirement if the parties to the instrument are not related¹⁰ and the parties determine, based on *bona fide* arm's length negotiations between them, that the fair market value of the instrument after the modification or alteration is substantially equivalent to the fair market value of the instrument before the change (again, taking into account any one-time payment that is made in connection with the change) (the "Arm's Length Safe Harbor").

The Arm's Length Safe Harbor should work reasonably well in many OTC agreement situations. However, it implicates some practical complexities in many other circumstances. Many financial transactions using IBOR rates are widely syndicated and often have an arranger or indenture trustee that interacts with the debtor. As drafted, it is unclear if the participation and agreement of a syndicator or indenture trustee, for example, constitutes a determination by a party "to the debt instrument." In addition, in the case of an indenture trustee, the trustee may be resistant to take any action that it deems to constitute the exercise of discretion. Given the general difficulty of accessing the noteholders in many transactions, market participants may prefer or require that the replacement generally rely on the judgment of borrower-side parties in one form or another. In that case, the Arm's Length Safe Harbor would be unavailable. While the unilateral option alteration exception under existing Treasury Regulation § 1.1001-3 (described earlier) could still be available, given the various possible commercial considerations that might influence the borrower-side replacement mechanics, the certainty of its application may not always be apparent. As such, more comprehensive relief from Treasury could have provided a compliance-friendly safe harbor that did not sacrifice the argument that the replacement of an IBOR rate is pursuant to a unilateral option.

The preamble provides that the Substantial Equivalence Requirement is intended to “broadly facilitate the transaction away from IBORs.” Thus, it doesn’t appear the requirement is intended to be onerous on taxpayers and necessarily require the use of the safe harbors. However, many deals include an opinion requirement at a high degree of comfort that there is no deemed reissuance. It could be reasonably expected in such cases for taxpayers and their advisors to require reliance on the two safe harbors.

In addition to the requirements discussed above, a rate is only a qualified rate if the interest rate benchmark to which the rate refers after the modification or alteration and the IBOR rate to which the instrument referred before the modification or alteration are based on transactions conducted in the same currency or are otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency.

Source and Character of One-Time Payments

When replacing an IBOR rate with a fallback rate the issuer of an instrument may decide to make a one-time payment to its counterparty in lieu of making a spread adjustment. The question from a federal tax perspective is the source and the character of this one-time payment. For example, if the issuer of a debt instrument makes a one-time payment in lieu of a spread adjustment when replacing LIBOR, is that payment interest subject to withholding under section 1441 (and possibly exempt from withholding under the portfolio interest exemption)?

The Proposed Regulations provide that for purposes of the Code, the source and the character of such a one-time payment that is made by a payor in connection with the modification or alteration of an instrument to replace an IBOR rate is the same as the source and character that would otherwise apply to a payment made by the payor with respect to the instrument.¹¹ The preamble to

the Proposed Regulations includes an example of a lease of real property; in that case, a one-time payment made by a lessee to the lessor is treated as a payment of rent, and the source of that one-time payment is the location of the real property.

With respect to debt instruments, the rule does not explicitly address whether a one-time payment would be considered a payment of interest or a payment of principal. If the payment were treated as principal, the instrument would then have market discount equal to the reduction in basis. The Proposed Regulations are silent on the proper treatment, although one reasonable interpretation given the real property lease example mentioned above is that the one-time payment would be viewed by the IRS as a payment of interest, with the source generally being the residence of the payor.

The Proposed Regulations also state that the Treasury and the IRS expect that parties to instruments will replace IBORs with an overnight, nearly risk-free rate such as SOFR. Since the Treasury and IRS expect a SOFR rate to be lower than its IBOR rate equivalent, the Proposed Regulations do not contemplate a one-time payment going the other way (i.e., from the lender to the borrower). The Proposed Regulations seek comments on what the source and character of a one-time payment should be in this case. One approach would be to adopt the rules for amortizable bond premium to such a payment. In this case, the payment would be treated as an offset to the interest on the bond.

Guidance for REMICs

The replacement of an IBOR rate presents three federal tax considerations for REMICs. First, among other requirements for an entity to be qualified as a REMIC, the regular interests of the REMIC must be issued on the startup day with fixed terms.¹² Absent IRS guidance that a replacement of an IBOR is not a significant modification, if a REMIC regular interest has the mechanics to change its reference rate from an IBOR to something else, there is a risk the regular interest could be viewed as being issued without

fixed terms. Second, also among the other requirements for an entity to be qualified as a REMIC, REMIC regular interests are only permitted to have certain specified contingencies.¹³ Fallback language specifying a fallback rate could potentially cause a regular interest to fail this requirement despite the fact that the contingency is to switch to an economic equivalent of an IBOR. Finally, there is a risk that expenses incurred to alter a regular interest could be viewed as causing the payments of principal and interest on the regular interest to be subject to a contingency, which could disqualify the interest as a regular interest.

The Proposed Regulations provide guidance on each of these considerations.¹⁴ First, the Proposed Regulations provide that a change in the reference rate for a regular interest after the REMIC start-up day that meets the two tests to be a “qualified rate” discussed above is disregarded in determining whether the regular interest has fixed terms on the REMIC startup day. In addition, the regulations state that an interest in a REMIC does not fail to qualify as a regular interest solely because it is subject to a contingency whereby a rate that references an 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. Finally, the Proposed Regulations provide that 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 incurred to replace an IBOR. Relatedly, the regulations provide that payments of such expenses by a third party will not be considered to be a contribution to the REMIC under the REMIC rules.

Ancillary Provisions

There was concern before the Proposed Regulations were issued that the replacement of an IBOR could affect the grandfather status of instruments under the repealed TEFRA rules, section 871(m) of the Code, and under the Foreign Account

Tax Compliance Act (“FATCA”). The Preamble to the Proposed Regulations states a truism, which is that if there is no deemed exchange of an instrument on account of an IBOR replacement (or an addition of a fallback mechanic) because it satisfies the requirements of the Proposed Regulations, the grandfathered status of such instrument is not impacted. In the case of FATCA and non-debt contracts, the Proposed Regulations specifically provide that the replacement of an IBOR or the addition of a fallback mechanic that satisfies the tests of the Proposed Regulations is not a material modification under the FATCA regulations.

The Proposed Regulations also provide guidance on the effect of an IBOR replacement on integrated transactions and hedges and the rules pursuant to which non-US banks that maintain US branches compute interest expense. Specifically, non-US banks may use SOFR in determining their interest expense on excess US-connected liabilities without requesting a change in accounting method from the IRS.

IBOR Replacement Mechanics and the VRDI Rules

Perhaps more of interest to tax practitioners than IBOR enthusiasts in general (we know you are out there), the Proposed Regulations also address a rule under the VRDI regulations (governing floating rate debt instruments) that could have potentially caused floating rate debt instruments qualifying as VRDIs to be treated as issued with original issue discount (“OID”). Under the VRDI regulations, when an instrument pays interest at a single QFR, stated interest is considered to be qualified stated interest (a “QFR”), not resulting in OID. However, if an instrument provides for interest at two or more QFRs, the OID determination becomes more complicated. The applicable regulations require that each QFR be converted to a fixed rate substitute that equals the value of the QFR on the testing date. In a case where one fixed rate substitute exceeds the other by more than a *de minimis* amount, the excess will be treated as OID.¹⁵ If two QFRs can reasonably

be expected to have approximately the same value throughout the term of the debt instrument, the instrument is treated as having one QFR.¹⁶

The concern was that a VRDI linked to an IBOR rate with another QFR as a fallback might be viewed as having two QFRs for purposes of the rules discussed above. The Proposed Regulations alleviate this concern, stating that where a VRDI provides for both an IBOR rate that is a QFR and a methodology to change the IBOR to a different rate in anticipation of the IBOR becoming unavailable or unreliable, the two rates are treated as a single QFR for purposes of the VRDI regulations (and therefore the OID analysis above is not necessary).¹⁷ The regulations also provide that the possibility that an IBOR rate will become unavailable is treated as a remote contingency for purposes of the OID regulations and that the fact that an IBOR becomes unavailable or unreliable is not treated as a change in circumstances under the OID regulations (which could both otherwise potentially cause complications).

Effective Dates

In general, the Proposed Regulations will become effective when final regulations are published in the Federal Register, but taxpayers can rely on them before that date (provided, in some cases, that the regulations are applied consistently before final regulations are published).

Observation

Market participants need to make decisions today on what standard from the Proposed Regulations, if any, to include in their documentation. As discussed in this Legal Update, some aspects of the Proposed Regulations may receive pushback and may be subject to change in the final regulations. One approach for certain deals is to include a flexible standard in deal documentation until final regulations are issued. For example, an indenture could provide that the issuer will use commercially reasonable efforts to satisfy any applicable IRS guidance so that the replacement of an IBOR will

not be treated as a deemed exchange under section 1001 of the Code.

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Endnotes

- ¹ The Proposed Regulations are available at <https://www.govinfo.gov/content/pkg/FR-2019-10-09/pdf/2019-22042.pdf>.
- ² For a detailed discussion of the ARRC recommended waterfalls, some of the federal tax considerations of concern before the Proposed Regulations were issued, and the industry group letters to the IRS, see Brennan W. Young and Thomas A. Humphreys, “Breaking Up With LIBOR,” Tax Notes Federal (September 9, 2019).
- ³ See Prop. Treas. Reg. section 1.1001-6(d).
- ⁴ See Prop. Treas. Reg. section 1.1001-6(b)(1).
- ⁵ Treas. Reg. section 1.1275-5(b)(1).
- ⁶ See Prop. Treas. Reg. section 1.1001-6(b)(2).
- ⁷ The historic average can be determined by (a) using any industry-wide standard, such as a method of determining a historic average recommended by the International Swaps and Derivatives Association or the ARRC for the purpose of computing the spread adjustment for a rate that replaces an IBOR rate or (b) 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 modification or alteration and ending no earlier than three months before the modification or alteration. This 10-year period is somewhat peculiar, since SOFR, for example, was first published only a year and a half ago in April 2018. The Proposed Regulations provide that the historic average must be determined for both rates using the same method and historical data from the same timeframes and must be determined in good faith by the parties with the goal of making the fair market value of the instrument with the new rate substantially equivalent to the fair market value of the instrument before the alteration or modification.
- ⁸ See <https://apps.newyorkfed.org/markets/autorates/SOFR/> for SOFR, compared with <https://www.global-rates.com/interest-rates/libor/american-dollar/usd-libor-interest-rate-overnight.aspx> for overnight LIBOR. See Daniel Kruger and Vipal Monga, “Repo-Market Tumult Raises Concerns About New Benchmark Rate,” the *Wall Street Journal* (September 23, 2019), available at <https://www.wsj.com/articles/repo-market-tumult-raises-concerns-about-new-benchmark-rate-11569247352/>.
- ⁹ In the case of a replacement of a LIBOR rate, for instance, measurement of this test would occur on the date of the LIBOR rate replacement.
- ¹⁰ The Proposed Regulations cross reference sections 267(b) and 707(b)(1) in defining relatedness, which generally define the term to mean parties related by more than 50 percent ownership, directly or indirectly.
- ¹¹ See Prop. Treas. Reg. section 1.1001-6(d).
- ¹² Code section 860G(a)(1).
- ¹³ See Treas. Reg. sections 1.860G-1(a)(5) and 1.860G-1(b)(3).
- ¹⁴ See Prop. Treas. Reg. section 1.860G-1.
- ¹⁵ Treas. Reg. section 1.1275-5(e)(3).
- ¹⁶ Treas. Reg. section 1.1275-5(b)(1).
- ¹⁷ See Prop. Treas. Reg. section 1.1275-2(m).

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