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TREASURY RELEASES GUIDANCE ON THE TRANSITION FROM LIBOR TO OTHER REFERENCE RATES

To Our Clients and Friends:

On October 9, 2019, the Department of the Treasury ("Treasury") published proposed regulations on the transition from interbank offered rates ("IBORs") to other reference rates (the "Proposed Regulations").[1] A broad range of financial instruments are based on the London interbank offered rate ("LIBOR"). LIBOR, however, may be phased out after the end of 2021.[2] The Proposed Regulations address the tax consequences of the transition away from LIBOR in response to concerns raised by the Alternative Reference Rate Committee ("ARRC").[3]

The ARRC's overarching concern was that modifying a financial instrument to replace LIBOR with another reference rate (*e.g.*, SOFR) might trigger adverse tax consequences for either the issuer or the holder. Without additional guidance, existing tax rules could potentially cause all holders of LIBOR-based instruments to realize gain or loss upon the replacement of LIBOR with another reference rate.[4]

To address the concerns of the ARRC regarding the adverse tax implications of modifying a financial instrument to replace LIBOR with an alternative reference rate and to provide much needed clarity, the Proposed Regulations provide that:

1. Replacing LIBOR with another reference rate or adding a "fallback" provision (*e.g.*, a provision stating that LIBOR will be replaced with another reference rate upon its elimination) to a financial instrument is not a realization event and will not cause recognition of gain or loss.

2. Replacing LIBOR or adding a fallback provision will not cause recognition of gain or loss under the integrated transaction rules.

3. Replacing LIBOR or adding a fallback provision will not cause recognition of gain or loss under the hedge accounting rules.

4. A one-time payment made by one party to a financial instrument to another to account for any difference between LIBOR and the rate replacing it has the same character and source as other payments made by the same party with respect to the instrument.

5. The existence of a fallback provision will not cause a debt instrument providing for a floating rate to be treated as a contingent payment debt instrument.

6. Replacing LIBOR or adding a fallback provision in the organizational documents of a REMIC will not cause regular REMIC interests to be reclassified as residual interests.

The deadline to submit comments on the Proposed Regulations is November 25, 2019. Taxpayers can generally choose to apply the Proposed Regulations to modifications of debt instruments and non-debt instruments occurring after October 9, 2019, so long as they apply the Proposed Regulations consistently.[5]

1. Realization of Gain or Loss

Current tax rules provide that gain or loss is realized upon the exchange of property for other property that differs materially in kind or in extent (such an exchange is a "realization event").[6] In the case of debt instruments, current tax rules also provide that a significant modification of the terms of an instrument is a realization event.[7] These rules further provide that the triggering of an existing "fallback" provision is not a significant modification,[8] since such a modification occurs by the operation of the existing terms of the instrument.[9] It is unclear, however, whether the addition of a fallback provision to an existing debt instrument or the outright substitution of another reference rate for LIBOR would constitute a significant modification.

The situation is even more uncertain in the case of non-debt instruments (*e.g.*, derivatives), as current tax rules do not explain when modifications of such instruments constitute realization events and do not, *a fortiori*, provide that the triggering of an existing fallback provision is not a realization event. And just as in the case of debt instruments, it is unclear whether adding a fallback provision or substituting another reference rate for LIBOR in a non-debt instrument would be a realization event.

The Proposed Regulations significantly reduce the uncertainty as to which modifications of financial instruments constitute realization events. The Proposed Regulations provide that, for both debt instruments and non-debt instruments (including derivatives, stocks, insurance contracts, and lease agreements), neither the addition of a fallback provision nor the outright substitution of another reference rate for LIBOR is a realization event,[10] provided that the following conditions are satisfied:

1. The new reference rate must be a "qualified rate." Conveniently, Treasury provides a list of such rates, a list which includes SOFR.[11]

2. The fair market value of the instrument after modification must be "substantially equivalent" to its fair market value before modification.[12] Thankfully, Treasury also provides two safe harbors under which this substantial equivalence condition is deemed satisfied.[13]

3. The new reference rate must generally be based on transactions conducted in the same currency as the rate it replaces.[14] In the case of USD LIBOR, this means that the new reference rate must be based on transactions conducted in U.S. dollars, as is the case with SOFR.

The Proposed Regulations also provide that modifications of an instrument that are *associated* with the addition of a fallback provision or the substitution of another qualified rate for LIBOR are not realization events.[15] These modifications, however, are only covered to the extent they are reasonably necessary to effect the addition or substitution.[16] For example, the Proposed Regulations provide that modifying a financial instrument to add the obligation for one party to make a one-time payment to the other is not a realization event, so long as adding such an obligation is reasonably necessary to effect the replacement of LIBOR with another qualified rate.[17]

The Proposed Regulations also clarify that financial instruments that were issued before certain dates and are "grandfathered" under certain provisions of the Code, including sections 163(f), 871(m), and 1471, will not lose their grandfathered status as a result of the addition of a fallback provision or the substitution of another reference rate for LIBOR.[18]

2. Integrated Transactions

Issuers of debt instruments often enter into derivative contracts (*e.g.*, interest rate swaps or credit default swaps) to hedge against risk. Under current tax rules, a hedge and the debt instrument to which it relates may be integrated and taxed as a single synthetic debt instrument ("SDI"), instead of being taxed as two separate instruments.[19] The rationale behind this rule is that, if the combined cash flows from a debt instrument and a hedge are substantially equivalent to the cash flows on a single debt instrument, then the debt instrument and its hedge should be taxed just as if they were such an instrument.[20]

The holder of an SDI "legs out" of an integrated transaction when it disposes of one (or both) of its components.[21] Legging out causes the integrated transaction to terminate and results in the holder of the defunct SDI being treated as having sold it for fair market value.[22] Absent further guidance, the addition of a fallback provision or the outright substitution of another reference rate for LIBOR in either components of an SDI may have caused a legging out resulting in realization of gain or loss.

The Proposed Regulations avoid this result and clarify that the amendment of any of the components of an integrated transaction to replace LIBOR with another reference rate is not a legging out, so long as the transaction, as modified, continues to qualify for integration.[23] Thus, an integrated transaction composed of a LIBOR-based debt instrument and interest rate swap is not terminated by reason of the substitution of SOFR for LIBOR in either the debt instrument or the swap.[24]

3. Hedge Accounting

Under current tax rules, taxpayers using the accrual method of accounting must account for hedging transactions in a way that clearly reflects income.[25] In other words, the method of accounting used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of the income, deduction, gain, or loss of the items being hedged.[26] This general rule applies to hedges of debt instruments.[27]

Importantly, a taxpayer who retains a hedge while disposing of the items being hedged is required to match the built-in gain or loss in the former to the gain or loss realized on disposition of the latter.[28] A taxpayer can meet this requirement by marking the hedge to market on the date it disposes of the items being hedged.[29]

The Proposed Regulations provide that a modification of the terms of a debt instrument or derivative to replace LIBOR with another reference rate is not treated, for purposes of the hedge accounting rules, as a disposition or termination of either instrument.[30] This means that such a modification will not cause the taxpayer to realize gain or loss. The holder of a LIBOR-based debt instrument who enters into a LIBOR-based interest rate swap as a hedge, for instance, will not be required to mark either instrument to market upon the replacement of LIBOR with another reference rate in either.

4. One-Time Payments

The character of a one-time payment made by one party to a financial instrument to another party to account for the difference between the old rate and the new rate may be ambiguous. It is unclear, for instance, whether current tax rules would treat a one-time payment by a borrower to a lender in relation to the substitution of SOFR for LIBOR in a debt instrument as an interest payment or as a fee. Any ambiguity as to the character of a one-time payment implies an ambiguity as to whether it should be sourced to either the U.S. or another jurisdiction.

The Proposed Regulations provide that the character and source of a one-time payment made by a payor in connection with the addition of a fallback provision or the outright substitution of an another reference rate for LIBOR in a financial instrument are the same as the source and character that would otherwise apply to a payment by the same party with respect to the instrument.[31] As a result, a one-time payment by a borrower in relation to the substitution of SOFR for LIBOR in a debt instrument would indeed be treated as an interest payment and would therefore be sourced as such.[32]

5. Original Issue Discount and Qualified Floating Rates

Under current tax rules, debt instruments providing for a floating rate may be classified as either variable rate debt instruments ("VRDIs") or contingent payment debt instruments ("CPDIs"). VRDIs generally benefit from an advantageous tax treatment compared to CPDIs. For instance, if a VRDI provides for stated interest that is unconditionally payable at least annually at a single qualified floating rate ("QFR"), then all of the stated interest on this VRDI is qualified stated interest.[33] This means that stated interest payments on such an instrument will not create original issue discount ("OID").

In plain English, this means that the holder of a VRDI will not be required to include interest payments in income until it has received them (under its method of accounting).[34] By contrast, the holder of a CPDI may be required to include these payments in income before receiving them.[35]

The Proposed Regulations provide that, in the case of a debt instrument including a fallback provision, the LIBOR-based floating rate (provided it is a QFR) and the rate (e.g. a SOFR-based rate) that automatically replaces it upon the occurrence of a triggering event are treated as a single QFR.[36] Additionally, the Proposed Regulations state that the possibility that an IBOR—including LIBOR—will become unavailable is treated as a remote contingency and therefore will not cause a debt instrument containing a fallback provision to be classified as a CPDI.[37] Finally, the Proposed Regulations provide that the occurrence of an event triggering a fallback provision does not qualify as a change in circumstances and does not, as a result, cause the instrument to be treated as retired and reissued.[38] As a result, the triggering of a fallback provision does not cause a realization event.

6. REMICs

A real estate mortgage investment conduit ("REMIC") is an entity formed for the purpose of holding a fixed pool of mortgages secured by interests in real property. REMICs issue both regular and residual interests. Under current tax rules, a regular interest in a REMIC is treated as a debt instrument.[39] Any REMIC interest that is not a regular interest is a residual interest.[40] The tax treatment of holders of regular interests is generally more advantageous than that of holders of residual interests.

For a REMIC interest to be a regular interest, the REMIC's organizational documents must, on the startup day, irrevocably specify the interest rate (or rates) used to compute any interest payments on the regular interest.[41] The addition of a fallback provision to the terms of a REMIC's organizational documents or the outright substitution of another reference rate for LIBOR would therefore cause all interests in this REMIC to be residual interests. Similarly, the possible triggering of an existing fallback provision by the elimination of LIBOR is treated by current tax rules as a contingency that prevents an interest in a REMIC from being a regular interest.[42]

In both cases, the Proposed Regulations provide relief to taxpayers. First, the Proposed Regulations explain that modifications of the terms of a REMIC's organizational documents after the startup day to add a fallback provision or substitute another reference rate for LIBOR are disregarded for purposes of determining whether an interest in a REMIC is a regular interest.[43] Second, the Proposed Regulations state that the possibility that LIBOR will be replaced by another reference rate as the result of a fallback provision being triggered is not a contingency that will prevent a REMIC interest from being a regular interest.[44] The Proposed Regulations also provide that parties may agree to reduce the amounts of payments of principal or interest to account for the reasonable costs of replacing LIBOR with another reference rate without thereby jeopardizing the status of REMIC interests as "regular."[45]

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[1] Guidance on the Transition From Interbank Offered Rates to Other Reference Rates, 84 Fed. Reg. 54068 (Oct. 9, 2019).

[2] The UK Financial Conduct Authority ("UK FCA") announced in 2017 that it would not compel or persuade banks to submit to LIBOR and that it would therefore not be necessary for the FCA to sustain LIBOR through its influence or legal powers. *See* The Future of LIBOR, Speech by Andrew Bailey, Chief Executive of the UK FCA (July 27, 2017), *available at* https://www.fca.org.uk/news/speeches/the-future-of-libor.

[3] The ARRC is a group of diverse private-market participants convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York to help ensure successful transition from U.S. dollar ("USD") LIBOR to the recommended alternative Secured Overnight Financing Rate ("SOFR"). More information on the ARRC is *available at* https://www.newyorkfed.org/arrc.

[4] *See* section 1001 of the Internal Revenue Code and § 1.1001–3(b) of the Treasury Regulations (discussed in detail below). Except where expressly stated otherwise, all section references are to the Internal Revenue Code of 1986, as amended ("I.R.C."), and the Treasury Regulations ("Treas. Reg.") promulgated thereunder.

[5] Proposed Treasury Regulations ("Prop. Treas. Reg.") § 1.1001-6(g).

[6] Treas. Reg. § 1.1001–1(a).

[7] Treas. Reg. § 1.1001–3(b).

[8] Treas. Reg. § 1.1001–3(c)(1)(ii).

[9] *Id.*

[10] Prop. Treas. Reg. § 1.1001-6(a)(1)-(3). Although the Proposed Regulations do not explicitly say so, they are naturally read as implying that the triggering of an existing fallback provision in a non-debt instrument is not a realization event.

[11] Prop. Treas. Reg. § 1.1001-6(b)(1)(i).

[12] Prop. Treas. Reg. § 1.1001–6(b)(2)(i).

[13] Prop. Treas. Reg. § 1.1001–6(b)(2)(ii).

[14] Prop. Treas. Reg. § 1.1001–6(b)(3).

[15] Prop. Treas. Reg. § 1.1001-6(a).

[16] Prop. Treas. Reg. § 1.1001-6(a)(5).

[17] *Id.*

[18] Prop. Treas. Reg. § 1.1001-6(e).

[19] Treas. Reg. § 1.1275-6(a)

[20] *Id.*

[21] Treas. Reg. § 1.1275-6(d)(2)(i)(A).

[22] Treas. Reg. § 1.1275-6(d)(2)(i)(B).

[23] Prop. Treas. Reg. § 1.1001-6(c).

[24] *Id. See also* 84 Fed. Reg. 54068, 54073 (Oct. 9, 2019). The Proposed Regulations provide similar rules for foreign currency hedges integrated with debt instruments under Treas. Reg. § 1.988–5(a) and interest rate hedges integrated with tax-exempt bonds under Treas. Reg. § 1.148–4(h).

[25] Treas. Reg. § 1.446-4(b).

[26] *Id.*

[27] Treas. Reg. § 1.446-4(e)(4).

[28] Treas. Reg. § 1.446-4(e)(6).

[29] *Id.*

[30] Prop. Treas. Reg. § 1.1001-6(c).

[31] Prop. Treas. Reg. § 1.1001-6(d).

[32] Although the proposed regulations do not address the case in which a lender makes a one-time payment to a borrower, Treasury has requested comments on the source and character of such a payment. 84 Fed. Reg. 54068, 54073.

[33] Treas. Reg. § 1.1275-5(e)(2)(i).

[34] Treas. Reg. § 1.1275-5(e).

[35] Treas. Reg. § 1.1275-4.

[36] Prop. Treas. Reg. § 1.1275–2(m)(3).

[37] Prop. Treas. Reg. § 1.1275-2(m)(3).

[38] Prop. Treas. Reg. § 1.1275-2(m)(4), Treas. Reg. section 1.1275-2(h)(6).

[39] I.R.C. § 860G(a)(1).

[40] I.R.C. § 860G(a)(2).

[41] Treas. Reg. § 1.860G–1(a)(4)

[42] Treas. Reg. § 1.860G-1(b)(3).

[43] Prop. Treas. Reg. § 1.860G–1(e)(2).

[44] Prop. Treas. Reg. § 1.860G–1(e)(3). This rule applies so long as the LIBOR-based rate and the fallback rate are each rates permitted under I.R.C. § 860G.

[45] Prop. Treas. Reg. § 1.860G–1(e)(4).

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Tax or Financial Institutions practice groups, or the following authors:

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