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Client Alert

Commentary

Latham & Watkins Transactional Tax Practice | October 22, 2019 | Number 2552

US Treasury Alleviates Tax Risk From Interbank Offered Rates Phase-Out

The Proposed Regulations allow existing debt and non-debt contracts that now reference LIBOR and other Interbank Offered Rates (IBORs) to transition toward alternative reference rates without triggering tax.

Key Points:

- Amendments to terms of instruments necessary to transition from IBORs generally do not result in a tax event, as long as the fair market value of the amended instrument is substantially equivalent to its fair market value prior to the amendment.
- The Proposed Regulations provide two safe harbors for determining the fair market values of instruments.
- Other amendments that are not necessary to transition from IBORs are analyzed under the generally applicable rules.

On October 9, 2019, the US Treasury and Internal Revenue Service (together, Treasury) published proposed regulations (the Proposed Regulations) that would allow market participants to switch from IBORs to new reference rates for existing contracts and adjust the terms as necessary, without treating each contract as exchanged for a new one in a taxable exchange. While many questions remain, the Proposed Regulations provide a welcome relief from some tax risks to market participants transitioning to alternative rates.

Background

As global regulators prepare to shift away from the London Interbank Offered Rate (LIBOR) and other IBORs, many existing debt instruments and non-debt contracts will need to be amended. Latham & Watkins previously addressed aspects of the transition in this *Client Alert*. In addition to the actual replacement of the reference rates, various administrative and operative terms may need to be changed, and onetime payments may be necessary to compensate parties for the different values of the rates. Under long-standing US tax rules, significant modifications to debt may be treated as a taxable exchange and reissuance, with potentially adverse consequences for both the lender and the obligor. Similarly, material changes to the terms of non-debt instruments, such as interest rate swaps, options, and other non-debt contracts, may result in a taxable exchange of the contract for a new one, causing counterparties to recognize gain or loss. The Proposed Regulations set out the conditions under which amendments to debt instruments and non-debt contracts can be made without triggering a taxable exchange.

The Proposed Regulations would apply to both debt and non-debt contracts and would be effective for changes made on or after the finalization of the Proposed Regulations. Taxpayers may elect to apply the Proposed Regulations to changes that occur before then, provided that they apply the Proposed Regulations consistently across related parties.

In addition to the key provisions that are the focus of this *Client Alert*, the Proposed Regulations address the determination of the "original issue discount" for instruments with fallback rates and several other points relevant to taxpayers subject to specific tax rules.

Effects of the Key Provisions of the Proposed Regulations

Replacement of Rates and Associated Alteration or Modification Do Not Result in a Tax Event

The Proposed Regulations generally provide that if the terms of a debt instrument or a non-debt contract are altered or modified to replace (or to provide a fallback to) an IBOR-referencing rate, the currency of the reference rate stays the same, and the fair market value of the instrument or contract after the alteration or modification remains substantially equivalent to the fair market value of such instrument or contract prior to that alteration or modification, such alteration or modification is not treated as a taxable exchange of the debt instrument or the non-debt contract.

The change in terms may include any associated alterations or modifications that are reasonably necessary to effectuate the transition to an alternative rate. The associated alterations or modifications may be technical, administrative, or operational adjustments, such as changes in interest periods, timing, or frequencies of payments.

In addition, an associated alteration or modification may include a onetime payment between the parties to compensate for the difference between the value of the IBOR-referenced rate and the relevant alternative rate. The Proposed Regulations suggest that the onetime payment is treated as any other payment made under the relevant debt instrument or non-debt contract, with the same source and character as other payments.

Qualifying Rates

The Proposed Regulations cover the transition to any alternative rate that is a qualifying rate. Qualifying rates are broadly defined to include most floating rates, with the most designated replacement rates specifically mentioned. For example, the Proposed Regulations specifically list the USD Secured Overnight Funding Rate (SOFR), the Sterling Overnight Index Average (SONIA), the Tokyo Overnight Average Rate (TONAR or TONA), and other similar rates in different jurisdictions. In addition, any other rate that is selected, endorsed, or recommended by the central bank, reserve bank, monetary authority, or similar institution as a replacement for an IBOR or similar rate in that jurisdiction would qualify. The Treasury may designate additional qualifying rates in the future. Finally, any rate that is determined by reference to a qualifying rate (by adding, subtracting, or multiplying such rate) would qualify.

Fair Market Value Determination

The fair market values of the relevant instruments before and after the alterations or modifications may be determined by any reasonable method consistently applied, and must take into account any onetime payment in connection with the alteration or modification.

The Proposed Regulations provide two safe harbors that treat the fair market values of the contracts as substantially equivalent before and after the alteration or modification:

1. Safe Harbor for Fair Market Value Negotiated by Unrelated Parties

The fair market values of the contracts before and after the alteration or modification would be treated as substantially equivalent, as long as the values are determined to be substantially equivalent based on bona fide, arm's length negotiations between unrelated parties.

2. Safe Harbor for Fair Market Value Based on Historic Average of Rates

The second safe harbor treats the substantial equivalency test as satisfied, as long as on the date of the alteration or modification, the historic average of the relevant IBOR-referencing rate does not differ by more than 25 basis points (*i.e.*, 0.25%) 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 the value of any onetime payment that is made in connection with the alteration or modification. For this purpose, a historic average may be determined by using an industry-wide standard (*e.g.*, recommended by ISDA, the Alternative Reference Rates Committee, or a comparable non-US organization or non-US regulator). In addition, any reasonable method may be used as long as it 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 the alteration or modification. The historic average for both rates must be determined using the same method and the same timeframe, and must be determined by the parties in good faith with the goal of making the fair market values of the contracts substantially equivalent.

Effect on Integrated Transactions and Grandfathering

Integrated Transactions. The Proposed Regulations confirm that for integrated transactions and those transactions identified as hedging transactions, the alterations or modifications of the components that do not cause a taxable exchange pursuant to the Proposed Regulations would not affect the tax treatment of the integrated transactions or of the identified hedged transactions, provided they otherwise continue to qualify for integration or hedging transaction treatment.

Grandfathering. Since the Proposed Regulations generally prevent debt instruments and non-debt contracts from being treated as exchanged and reissued, a debt instrument would not lose its grandfathered status under certain rules that do not apply to debt instruments issued prior to their effective dates (*e.g.*, registered debt, withholding imposed on dividend equivalent payments, and FATCA).

Other Contemporaneous Changes

If any other alterations or modifications are made to the terms of debt or non-debt contracts contemporaneously with the changes described in the Proposed Regulations, the tax effect of such other alterations or modifications must be determined under the generally applicable rules, while treating all the IBOR-transition related changes as a part of the initial terms of the relevant debt or non-debt contracts.

Effective Date

The Proposed Regulations would apply to changes made on or after the finalization of the Proposed Regulations. Taxpayers may elect to apply the Proposed Regulations to changes that occur before then, provided that they apply the Proposed Regulations consistently across related parties.

Observations

- The Proposed Regulations provide a welcome relief for unrelated market participants that negotiate amendments to outstanding contracts, to minimize tax consequences of the transition away from IBORs.
- Whether the Proposed Regulations contemplate any formal documentation of the parties' agreement regarding the fair market values of the contracts in order for the arm's length negotiation safe harbor to apply is unclear.
- How the arm's length negotiation safe harbor applies to setting the terms of a publicly held instrument if the parties do not engage in direct negotiation is also unclear.
- The currency of the rate benchmark must remain the same as the currency in which the IBOR-referencing rate was determined. For example, a switch from a USD LIBOR to a rate based on Sterling SONIA would not qualify as tax-free under the Proposed Regulations, but rather would be subject to the general deemed exchange rules.
- Even though the change in terms might not trigger a taxable exchange, the onetime payment received as part of the transition would have the same source and character as other payments with respect to the instrument. The treatment of such onetime payment may not be clear if the instrument contemplates different payments that may have a different character or source.

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