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Tax Relief May Be Ahead for Market Participants Transitioning Away From LIBOR

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Tax relief may be coming for issuers and holders of debt instruments and parties to derivatives and other financial contracts governed by LIBOR (the London Interbank Offered Rate). The IRS published new proposed regulations (available at: https://www.federalregister.gov/documents/2019/10/09/2019-22042/guidance-on-the-transition-from-interbank-offered-rates-to-other-reference-rates) on October 9 to address tax concerns as parties have begun to modify financial instruments' reference rates in anticipation of a potential phasing out of LIBOR at the end of 2021. The new regulations clarify Internal Revenue Code section 1001, which provides when a tax gain or loss on a modification of a financial instrument is typically realized.

As part of a larger effort by the Federal Reserve and the Treasury Department to limit disruption in the financial industry, the proposed rules provide the following:

- If a debt instrument, derivative or other financial contract is modified to replace or to provide an alternative rate from an interbank offered rate, such as LIBOR, to one based on an alternative rate, such as the secured overnight financing rate (SOFR), and the modification does not change the fair market value of the instrument or contract, then the change is not a modification that could result in a tax realization event.

- Two safe harbors provide clarity in determining whether an instrument's fair market value has changed as a result of a reference rate modification.

- These rules are intended to apply both to the issuer and the holder of the debt instrument and to each party to a nondebt financial contract.

Background

Initial requests for tax guidance on the phase-out of LIBOR came from the Alternative Reference Rates Committee (ARRC), which was tasked with selecting an alternative rate for USD LIBOR by the Board of Governors of the Federal Reserve and the Federal Reserve Bank of New York. Given the impending wave of amendments to financial instruments that rely solely on LIBOR, the ARRC has been lobbying for flexible guidance in determining the tax effects of the amendments. The ARRC recommended a new reference rate in March 2018 and, since then, has focused on easing the transition to the new benchmark.

Typically, under section 1001, a significant modification to the terms of a debt instrument is equivalent to an exchange of the original instrument for the modified instrument, potentially resulting in a taxable gain or loss. The new regulations will allow parties to avoid a tax realization event when an alteration or modification is made to a debt instrument that did not provide an alternative to LIBOR.

Analysis

To avoid negative tax consequences for these necessary amendments, the new regulations provide that replacing the current LIBOR standard with a qualified rate (as defined in the new regulations) will not be considered a modification of the debt instruments and, thus, will not be a tax realization event — as long as certain requirements are met. This rule will also apply to "associated alterations," like one-time payments that relate to the replacement of LIBOR. As part of this package of regulations, a similar regulation was also proposed for nondebt financial contracts, most notably derivatives, where parties wish to transition away from LIBOR. The guidance also allows for the same treatment of amendments that provide a fallback provision instead of an explicit change to the reference rate.

Under these proposed regulations, there will be no tax realization event following a modification that meets the parameters listed above as long as the fair market value of the debt instrument or the nondebt financial contract after the relevant alteration or modification is substantially equivalent to the fair market value before the alteration or modification. This change in value can be determined by "any reasonable valuation method" as long as the method is applied consistently and takes into account any one-time payments if agreed upon as part of the modification to the reference rate.

There are also two safe harbors provided for in the rules to determine the value of the pre- and post-modification instrument. If the historic average of the LIBOR-referencing rate and the historic average of the new reference rate are no more than 25 basis points apart, the first safe harbor will be met. Alternatively, if nonrelated parties to the instrument or contract determine that the fair market value of the original and modified instruments or contracts were the same through bona fide, arm's-length negotiations, the second safe harbor will be met.

The proposed regulations will go into effect immediately upon publication of final regulations in the *Federal Register*. All modifications made on or after the date of publication to the *Federal Register* will be covered by the regulations. Any modifications made before publication may also benefit from this new guidance if certain rules are followed before publication.

The relief provided by these regulations is similar to the relief from onerous accounting processes provided by the Financial Accounting Standards Board (FASB) in June that would normally be required when contracts are modified. FASB tentatively decided that, for a contract that meets certain criteria, a change in that contract's reference rate would be accounted for as a continuation of that contract rather than the creation of a new contract. This decision applies to loans, debt, leases and other arrangements.

Takeaway

These new regulations from the IRS will help smooth the transition away from LIBOR by limiting tax consequences when parties choose to amend debt instruments and nondebt financial contracts that do not provide an alternative to LIBOR. Safe harbors give parties additional clarity by providing a clear way to determine whether an instrument's value has changed before and after the modification.