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REPORT

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POTENTIAL FEDERAL TAX REISSUANCE CONCERNS INVOLVING A TRANSITION FROM LIBOR TO AN ALTERNATE RATE

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BACKGROUND

In 2017, the Financial Conduct Authority, the U.K. authority that oversees the London interbank offered rate ("LIBOR"), announced that LIBOR may be phased out after the end of 2021. The announcement applied to all currency and term variants of LIBOR, including U.S. dollar denominated LIBOR ("USD LIBOR"). The Financial Conduct Authority later confirmed that all LIBOR settings will either cease to be provided by any administrator or no longer be representative: (i) immediately after December 31, 2021, in the case of all sterling, euro, Swiss franc and Japanese yen settings, and the one-week and two-month U.S. dollar settings; and (ii) immediately after June 30, 2023, in the case of the remaining U.S. dollar settings.[1]

In response to the 2017 announcement, 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"*) to identify alternative reference rates that could be used to replace USD LIBOR. The ARRC was tasked with finding a replacement rate (or rates) that would be more robust than USD LIBOR and that would comply with certain standards. The ARRC recommended the Secured Overnight Financing Rate (*"SOFR"*) as a replacement for USD LIBOR.[2] The Federal Reserve Bank of New York began publishing SOFR daily as of April 3, 2018.

REISSUANCE CONCERNS

Existing debt instruments and non-debt contracts may have LIBOR-referenced provisions that could create significant difficulties (including changing the economics of a transaction) if LIBOR becomes unavailable or unsuitable. Accordingly, the parties to a transaction may wish to amend transaction documents to provide for a transition from a LIBOR-referenced rate to an alternate rate (or to an alternate fallback rate) if the documents do not already provide for such alternative rate (or in the case of a LIBOR-referenced fallback rate, when that fallback rate is based on subjective determinations).[3]

Concerns have been raised about possible federal tax consequences of amending certain debt instruments or non-debt

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contracts to provide for certain transitions from LIBOR[4] to another reference rate. Such amendments may involve (i) the replacement of a LIBOR rate with another reference rate, (ii) the replacement of a LIBOR fallback rate with another fallback reference rate (such as in the event of the unavailability or unsuitability of LIBOR), (iii) adjustments to the spread above the alternate base reference rate that will replace the LIBOR-referenced rate in order to account for the expected differences between the two base reference rates (which might represent term premium and credit risk inherent in the index), and/or (iv) a one-time, lump-sum payment in lieu of, or in addition to, such spread adjustment.

In addition to the replacement of a LIBOR-referenced rate for LIBOR-referenced debt instruments, such as tax-exempt bonds, market participants are also concerned with the replacement of LIBOR for LIBOR-referenced non-debt contracts, such as swaps, that may be currently integrated with a debt instrument. For example, a LIBOR-referenced issue of tax-exempt bonds may be integrated with a swap that also has a LIBOR-referenced rate.[5] Under current law, certain modifications to a debt instrument or to a non-debt contract could cause bonds with an integrated hedge to be treated as nonintegrated for certain federal tax purposes. Parties to an integrated transaction would also want a transition from LIBOR-referenced rates to alternate rates to be predictable so that there would not be a future mismatch of the rates (or the value of the rates) between the two instruments.

REISSUANCE REGULATIONS

Pursuant to current guidance from the Internal Revenue Service and pursuant to regulations under Section 1001 of the Internal Revenue Code of 1986, as amended (the *"Code"*) that have been promulgated by the U.S. Treasury (the *"Treasury Regulations"*), a significant modification to a debt instrument, such as a tax-exempt bond, could create a reissuance of such bond for federal tax purposes.[6] A modification is generally any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument.[7] In general, however, with certain exceptions, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification.[8]

The reissuance rules apply to any modification of a debt instrument, regardless of whether the modification takes the form of an amendment to the terms of the debt instrument or the form of an exchange of a new debt instrument for an existing debt instrument.[9] An alteration of a legal right or obligation that is a significant modification under the tests of the Treasury Regulations will generally cause a reissuance of the debt instrument for certain federal tax purposes.[10] The modified debt instrument is deemed to be reissued and is deemed to currently refund the unmodified debt instrument.

Under the current Treasury Regulations, the replacement of LIBOR with a new reference rate could, in certain circumstances, be considered to be a significant modification of a debt instrument and such modification could cause the debt instrument to be deemed to be reissued for certain federal tax purposes. In certain circumstances, modifying a LIBOR instrument to address the elimination of LIBOR could also cause a deemed termination or legging out of an integrated hedge that, in effect, dissolves the integration of the

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instruments into their component parts, which may create federal tax consequences or recognition events.

A deemed reissuance of a debt instrument (or deemed exchange of a non-debt contract) could result in the realization of income, deduction, gain or loss for federal income tax purposes, or other tax consequences for the holder of such debt instrument. In addition, a reissuance of tax-exempt bonds could result in various consequences to an issuer (or borrower, in the case of a conduit transaction),[11] including, among other things, loss of tax exemption, changes in yield for purposes of the arbitrage investment restrictions, failure to meet certain transition rules, acceleration of the obligation to pay arbitrage rebate, deemed termination of integrated interest rate swaps, inability to blend yield between a modified and unmodified instrument, new public approval requirements (if applicable), and change in law risk.

PROPOSED U.S. TREASURY REGULATIONS[12]

The U.S. Treasury published proposed regulations in the Federal Register on October 9, 2019 (the *"Proposed Regulations"*) to address certain federal tax concerns, including the reissuance concerns generally described above. The Proposed Regulations were drafted, in part, to address concerns regarding a potential federal tax reissuance of debt instruments and non-debt contracts transitioning from a LIBOR reference rate to a new rate or a new fallback rate and to minimize taxpayer burdens.

The Proposed Regulations generally provide that, if the terms of a debt instrument (such as a tax-exempt obligation) or the terms of a non-debt contract (such as a swap or hedge) are modified to provide an alternate rate, replace a LIBOR rate, provide an alternate fallback rate or to replace a fallback rate, such replacement rate will qualify as a "qualified rate" (more fully discussed below), if such alternate or replacement rate meets certain requirements. There are two separate requirements for such a replacement. One requirement concerns the type of rate that can be employed and the other relates to changes in the fair market value of the debt instrument (or non-debt contract) and whether there are changes to the currency of the reference rate. If all of these requirements are met, such modification does not create a reissuance.[13]

This general rule applies whether or not the modification occurs by an amendment to the terms of the debt instrument (or non-debt contract) or by an exchange of a new debt instrument (or non-debt contract) for the existing one.[14] The general rule also applies to "associated alterations" for debt instruments and "associated modifications" for non-debt contracts, which are alterations or modifications that are both associated with the replacement of the LIBOR rate (or inclusion of an alternate rate) and reasonably necessary to adopt or implement the replacement or inclusion.[15]

Accordingly, the Proposed Regulations provide (i) that an alteration to the terms of a debt instrument or non-debt contract to provide a qualified rate[16] as a replacement for a LIBOR referencing rate (or a fallback rate for a LIBOR referencing rate) and any associated alteration or associated modification is not treated as a modification, and (ii) that such alteration does not result in a deemed reissuance of a debt instrument or exchange of property for a non-debt contract for

purposes of Reg. Section 1.1001-3 (concerning the reissuance of a debt instrument) and Reg. Section 1.1001-1(a) (concerning the computation of gain or loss from the exchange of property, such as a swap), as applicable.[17] The Proposed Regulations also provide, however, that any other modifications of a debt instrument or a non-debt contract will need to be analyzed to determine whether such modifications, themselves, cause a reissuance of the debt instrument or an exchange of the non-debt contract.

QUALIFIED RATE

An important requirement for favorable treatment under the Proposed Regulations is that the new replacement rate or new fallback rate must be a qualified rate.[18] The Proposed Regulations also provide guidance for determining whether a rate is a type of rate that is a qualified rate and lists rates that are qualified rates for purposes of the Proposed Regulations.[19] The list includes any 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 LIBOR or its local currency equivalent in that jurisdiction.[20] Importantly, it also includes any rate that is a qualified floating rate under certain existing Treasury Regulations.[21] This last category is broad and generally includes any index or other mechanism that measures the contemporaneous cost of newly borrowed funds. For example, the SIFMA rate would likely fall into this category.

SUBSTANTIALLY EQUIVALENT VALUE

A rate is a qualified rate only if the fair market value of the debt instrument or non-debt contract after the alteration or modification is substantially equivalent to the fair market value before that alteration or modification.[22]

According to the preamble of the Proposed Regulations, this is to ensure that such alterations or modifications are generally no broader than is necessary to replace the LIBOR-referenced rate in the terms of the debt instrument or non-debt contract with a new reference rate. The Proposed Regulations also recognize that the fair market value of a debt instrument or non-debt contract may be difficult to determine precisely and therefore provide that the fair market value of a debt instrument or non-debt contract may be determined by any reasonable valuation method, as long as that reasonable valuation method is applied consistently and takes into account any one-time payment made in lieu of a spread adjustment.[23]

The Proposed Regulations also provide two safe harbors.[24] The first safe harbor provides that the value equivalence requirement is satisfied if, at the time of the alteration or modification, the historic average of the LIBOR-referencing 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 the value of any one-time payment that is made in connection with the alteration or modification.[25] For this purpose, a historic average may be determined by using an industry-wide standard, such as a method of determining a historic average recommended by the International Swaps and Derivatives Association for the purpose of computing the spread adjustment on a rate included as a fallback to a LIBOR referencing rate

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on a derivative or a method of determining a historic average recommended by the ARRC (or a comparable non-U.S. organization or non-U.S. regulator) for the purpose of computing the spread adjustment for a rate that replaces a LIBOR referencing rate on a debt instrument.[26]

A historic average may also be determined by 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 alteration or modification and ending no earlier than three months before the alteration or modification.[27]

In any application of this safe harbor, the parties must (i) use the same methodology and timeframes to compute the historic average for each of the rates to be compared, and (ii) use good faith with the goal of making the fair market value of the debt instrument or non-debt contract after the alteration or modification substantially equivalent to the fair market value of the debt instrument or non-debt contract before the alteration or modification.[28]

The second safe harbor provides that the value equivalence requirement is satisfied if the parties to the debt instrument or non-debt contract are not related[29] and the parties determine, based on *bona fide*, arm's length negotiations, that the fair market value of the debt instrument or non-debt contract before the alteration or modification is substantially equivalent to the fair market value of the debt instrument or non-debt contract after the alteration or modification.[30] In determining the fair market value of a debt instrument or non-debt contract after the alteration or modification, the parties must take into account the value of any one-time payment that is made in connection of the alteration or modification (*i.e.*, a payment that is made in lieu of a spread adjustment).[31]

The Proposed Regulations also generally require that, in order to be a qualified rate, the interest rate benchmark included in the replacement rate after the alteration or modification and the LIBOR-referenced rate prior to the alteration or modification 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.[32]

INTEGRATED TRANSACTIONS AND HEDGES

A taxpayer is generally permitted to alter the terms of a debt instrument or modify the terms of a derivative in an integrated or hedged transaction to replace a LIBOR referencing rate with a qualified rate without causing a reissuance of the debt instrument or an exchange of the derivative, provided that the integrated or hedged transaction, as modified, continues to qualify for integration.[33]

POSSIBLE ONE-TIME PAYMENT

It is also possible that the modification of an instrument may give rise to an agreed-upon one-time payment among the parties as compensation for any reduction in payments that may have been caused by the differences between LIBOR and a new alternate rate. In such circumstances, there may be questions about the source and character of the one-time payment for federal tax purposes.[34]

The Proposed Regulations provide that, for all purposes of the Code, the source and character of

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a one-time payment that is made by a payor in connection with an alteration or modification described herein will be the same as the source and character that would otherwise apply to a payment made by the payor with respect to the debt instrument or non-debt contract that is altered or modified.[35] For example, a one-time payment made by a counterparty to an interest rate swap is treated as a payment with respect to the leg of the swap on which the counterparty making the one-time payment is obligated to perform.

The Proposed Regulations generally expect that parties to debt instruments and non-debt contracts will generally replace LIBOR with an overnight, nearly risk-free rate. Because of differences in term and credit risk, an overnight, nearly risk-free rate will generally be lower than the LIBOR it replaces.

If such a payment is made with respect to a tax-exempt bond or an integrated transaction involving a tax-exempt bond, federal tax issues and covenant compliance issues could arise and issuers (and/or borrowers) should consult counsel.

EFFECTIVE DATE

The Proposed Regulations generally apply to the alteration or modification of the terms of a debt instrument or non-debt contract that occurs on or after the date of publication of a U.S. Treasury decision adopting these rules as final regulations in the Federal Register. The Proposed Regulations may generally be applied to an alteration or modification of a debt instrument or a non-debt contract that occurs before that date, provided that such rules are consistently applied before that date.[36]

CONCLUSION

Issuers and borrowers should be aware that LIBOR will be phased out and should prepare for such eventuality. Issuers and borrowers should therefore review their LIBOR-based transactions and consult with professionals to determine how to address LIBOR issues in their transaction documents.

Issuers and borrowers must determine which alternate rates best address the specifics of particular transactions. Issuers and borrowers should also be aware of changes to state law and administrative guidance. For example, there have been recent changes in New York law that will govern LIBOR transitions for contracts governed by New York law. *See* Senate Bill 297B/Assembly Bill 164B, signed by the New York governor in April 2021. In addition, issuers and borrowers should investigate issues related to LIBOR instruments, such as their exposure to LIBOR (and any borrowing or hedging needs prior to the end of LIBOR), tax and accounting matters, and potential issues concerning federal tax and securities compliance.

ENDNOTES:

[1]Announcements on the end of LIBOR, Financial Conduct Authority, first published May 3, 2021, at www.fca.org.uk/news/press-releases/announcements-end-libor.

[2]Although the ARRC has recommended SOFR as a replacement rate for USD LIBOR, the parties to a particular transaction, for various reasons, may prefer to select a replacement rate other than SOFR.

[3]Further, for LIBOR-based transactions, it is important to note that the language governing LIBOR in one transaction may be different from the language used in other LIBOR-based transac-

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tions of the parties (*i.e.*, different financial institutions have different form language) and such language may also vary among different LIBOR-based transactions of the same parties, depending on when the individual transactions occurred (*i.e.*, LIBOR language in documents, even language in form documents used by the same financial institution, has changed over time). Accordingly, parties may need to avoid a "one size fits all" approach to their various transactions.

[4] References to LIBOR herein include other interbank offered rates.

[5] Integration generally permits an issuer of tax-exempt bonds to treat payments under a swap that is integrated with the bonds as payments of interest on the bonds and is used in computing yield on the bonds. An issuer must take certain timely actions to integrate a swap with tax-exempt bonds; integration does not happen automatically.

[6] In addition, certain modifications to a non-debt contract, such as a swap, could cause an exchange of a non-debt contract. The exchange of a non-debt contract may be governed by Treasury Regulations different from those governing the modification of a debt instrument.

[7]*See* Reg. Section 1.1001-3(c).

[8]*See* Reg. Section 1.1001-3(c)(1)(ii).

[9]*See* Reg. Section 1.1001-3(a)(1).

[10]*See* Reg. Section 1.1001-3(b).

[11] A "conduit" borrower is typical in certain transactions involving tax-exempt private activity bonds, such as bonds issued for the benefit of an organization generally determined to be exempt from federal income tax under Section 501(c)(3) of the Code. For example, a state or local governmental issuer will issue the bonds and lend the proceeds to a Section 501(c)(3) organization pursuant to a loan agreement. A Section 501(c)(3) organization that borrows proceeds of a tax-exempt bond is typically called a "conduit" borrower in such transactions.

[12]Although this article only generally discusses federal reissuance or exchange concerns addressed by the Proposed Regulations, issuers and borrowers should also be aware that other proposals could impact the legal and economic considerations of a base rate transition from LIBOR. For example, there have been recent changes in New York law that will govern LIBOR transactions otherwise governed by New York Law. *See* Senate Bill 297B/Assembly Bill 164B, signed by the New York governor in April 2021. In addition, Revenue Procedure 2020-44 was published in October 2020 to provide fallback language to assist market participants as they prepared for the transition away from LIBOR.

[13]*See* Prop. Reg. Section 1.1001-6.

[14]*See* Prop. Reg. Section 1.1001-6.

[15]*See* Prop. Reg. Section 1.1001-6.

[16]*See* Prop. Reg. Section 1.1001-6(a)(1), (2), (3).

[17]*See* Prop. Reg. Section 1.1001-6(a)(1), (2), (3).

[18]*See* Prop. Reg. Section 1.1001-6.

[19]*See* Prop. Reg. Section 1.1001-6(b)(1). SOFR is a qualified rate. *Id.*

[20]*See* Prop. Reg. Section 1.1001-6(b)(1)(ix). A qualified rate also includes a qualified floating rate as defined in Reg. Section 1.1275-5(b), except that for this purpose a multiple of a qualified floating rate is considered a qualified floating rate. *See* Prop. Reg. Section 1.1001-6(b)(1)(x).

[21]*See* Prop. Reg. Section 1.1275-5(b).

[22]*See* Prop. Reg. Section 1.1001-6(b)(2).

[23]*See* Prop. Reg. Section 1.1001-6(b)(2).

[24]The Proposed Regulations also reserve the authority to provide additional safe harbors. *See* Prop. Reg. Section 1.1001-6(b)(2)(ii)(C).

[25]*See* Prop. Reg. Section 1.1001-6(b)(2)(ii)(A).

[26]*See* Prop. Reg. Section 1.1001-6(b)(2)(ii)(A).

[27]*See* Prop. Reg. Section 1.1001-6(b)(2)(ii)(A). The Proposed Regulations do not establish a minimum calculation period.

[28]*See* Prop. Reg. Section 1.1001-6(b)(2)(ii)(A).

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[29]Not related within the meaning of Section 267(b) or Section 707(b)(1) of the Code.

[30]*See* Prop. Reg. Section 1.1001-6(b)(2)(ii)(B).

[31]*See* Prop. Reg. Section 1.1001-6(b)(2)(ii)(B).

[32]*See* Prop. Reg. Section 1.1001-6(b)(3).

[33]*See* Prop. Reg. Section 1.1001-6(c).

[34]*See* Prop. Reg. Section 1.1001-6(d).

[35]*See* Prop. Reg. Section 1.1001-6(d).

[36]*See* Prop. Reg. Section 1.1001-6(g).

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