US IRS issues proposed rules addressing tax consequences of elimination of LIBOR and other interbank offered rates

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In light of the pending phaseout of the London interbank offered rate (LIBOR) and variant interest rates, the United States (US) Internal Revenue Service (IRS) has issued proposed regulations (REG-118784-18) addressing tax issues resulting from the transition to the use of reference interest rates other than interbank offered rates (IBORs) in debt instruments and other contracts.

Background

IBORs, including the US-dollar LIBOR (USD LIBOR), are planned to be phased out by the end of 2021, which has far-reaching financial and tax implications because the USD LIBOR is widely-used as a reference rate in a broad range of financial instruments. The Alternative Reference Rates Committee (ARRC)[1] of the Federal Reserve, tasked with selecting alternative rates, selected the Secured Overnight Financing Rate (SOFR) as the replacement for USD LIBOR. Other jurisdictions have selected other reference rates to replace IBORs for their respective currencies, including the Sterling Overnight Index Average (SONIA) to replace British pound sterling LIBOR, the Tokyo Overnight Average Rate (TONAR) to replace yen LIBOR and the Tokyo Interbank Offered Rate, and the Swiss Average Rate Overnight (SARON) to replace Swiss franc LIBOR.

In connection with the IBOR transition, the ARRC requested guidance from the Treasury Department on tax issues associated with the elimination of IBORs and the transition to other rates such as SOFR. Because the new reference rates differ from the IBORs they are intended to replace, it is expected that contracts

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will generally provide for a change to the spread over the interest rate (a spread adjustment) or a one-time payment for the change in value. ARRC also requested guidance on issues resulting from any spread adjustments or change-in-value payments.

Tax rules implicated by the transition from IBOR

Tax issues resulting from the change of the terms of existing debt instruments and other contracts to non-IBOR rates arise under various sections of the Internal Revenue Code,[2] including Sections 1001, 1275, 860G and 882, and corresponding regulations.

Section 1001 and the regulations thereunder generally provide that gain or loss is realized upon the exchange of property for other property differing materially either in kind or in extent. Treas. Reg. Section 1.1001-3 provides that a debt instrument differs materially in kind or in extent if it has undergone a "significant modification." Under the regulations, a modification is significant if, based on all of the facts and circumstances, the degree to which the legal rights and obligations of the parties are altered is economically significant. The regulations also contain a specific rule for a change in the yield of a debt instrument. However, it is not clear which test would apply to the change from an IBOR to an alternative rate and whether the change would constitute a significant modification. A significant modification results in the deemed exchange of the modified instrument for the original instrument and is a realization event.

Treas. Reg. Sections 1.988-5 and 1.1275-6 provide special rules under which debt instruments and other financial instruments used to hedge such debt instruments can be integrated, that is, treated as a single instrument for certain tax purposes. If a taxpayer disposes of one leg of an integrated transaction (including via a significant modification of a debt instrument or deemed exchange of the financial contract under Section 1001), it is generally treated as having terminated the integrated transaction and may realize gain or loss on all components of the transaction (including components that did not otherwise undergo a Section 1001 realization event).

Section 860G includes rules for real estate mortgage investment conduits (REMICs). Under Section 860G(a)(1), a regular interest in a REMIC must be issued on the startup day with fixed terms, and interest payments on a regular interest in a REMIC may be payable at a variable rate only to the extent provided in regulations.

Section 882 imposes tax on foreign corporations engaged in trade or business within the United States. Treas. Reg. Section 1.882-5 applies in determining a foreign corporation's interest expense allocable under Section 882(c) to income that is effectively connected with the conduct of a trade or business within the United States.

Proposed regulations

To facilitate the transition away from IBORs and minimize resulting market disruption, the IRS has issued the proposed regulations with an aim to reduce associated tax uncertainty and taxpayer burden. To this end, the proposed regulations include revisions and additions to the rules under Sections 1001, 1275, 860G and 882. Taxpayers may rely on the proposed rules before final regulations are issued to the extent specified in the proposed regulations.

Section 1001

The proposed regulations would add new Reg. Section 1.1001-6. Under Prop. Reg. Section 1.1001-6(a)(1), an alteration of the terms of a debt instrument to replace a rate referencing an IBOR with a "qualified rate" and any "associated alteration" would not be treated as a modification and, therefore, would not result in a taxable exchange of the debt instrument for purposes of Treas. Reg. Section 1.1001-3.

Qualified rates and associated alterations

With respect to non-debt contracts, Prop. Reg. Section 1.1001-6(a)(2) specifies that modifying a non-debt contract to replace a rate referencing an IBOR with a qualified rate (and any "associated modification") would not be treated as a deemed exchange of property for other property differing materially in kind or extent for purposes of Treas. Reg. Section 1.1001-1(a).

Under Prop. Reg. Section 1.1001-6(a)(3), an alteration to the terms of a debt instrument or modification to the terms of a non-debt contract to provide for the use of a qualified rate upon the discontinuation of an IBOR-referencing rate (and any associated alteration or modification), a so-called "fallback provision," would not be treated as a modification. In addition, the change to an existing fallback provision to substitute a qualified rate for an IBOR-referencing rate would similarly not be treated as a modification. Therefore, these changes would not result in an exchange of the debt instrument under Treas. Reg. Section 1.1001-3 or non-debt contract under Treas. Reg. Section 1.1001-1(a).

Any alteration or modification to the terms of a debt instrument or non-debt contract that is not given special treatment under Prop. Reg Section 1.1001-6 would continue to be subject to the ordinary operation of Treas. Reg. Section 1.1001-3 or 1.1001-1(a), respectively, by treating the amendments permitted by Prop. Reg. Section 1.1001-6 as being part of the terms of the instrument before any other alteration or modification.

The proposed rules in Prop. Reg. Section 1.1001-6(a) would apply to both the issuer and holder of a debt instrument and to each party to a non-debt contract.

Associated alteration or modification

An associated alteration or associated modification is any alteration of a debt instrument or modification of a non-debt contract that is associated with the alteration or modification that replaces or modifies the IBOR-referencing rate and that is reasonably necessary to adopt or implement the change. An associated alteration includes the addition of an obligation for one party to make a one-time payment in connection with the replacement of the IBOR-referencing rate with a qualified rate to offset the change in value that results from the replacement.

Qualified rate

Prop. Reg. Section 1.1001-6(b) provides a list of potential qualified rates including SOFR, SONIA, TONAR and SARON, or any rate selected, endorsed or recommended by the central bank, reserve bank, monetary authority or similar institution as a replacement for an IBOR or its local-currency equivalent (and any rate derived from these rates including by the addition or subtraction of a specified spread). However, Prop. Reg. Section 1.1001-6(b) states that a potential qualified rate will constitute a qualified rate only if the fair market value of the debt instrument or non-debt contract after the relevant alteration or modification is substantially equivalent to the fair market value before that alteration or modification (value equivalence requirement). For this purpose, the fair market value of a debt instrument or derivative may be determined by any reasonable valuation method, so long as the method is applied consistently and takes into account any one-time payment made in lieu of a spread adjustment.

The proposed regulations include two safe harbors with respect to the value equivalence requirement. Under the first safe harbor, the value equivalence requirement is satisfied if at the time of the alteration the historic average of the IBOR-referencing rate is within 25 basis points of the historic average of the rate that replaces it (taking into account any change of to the spread or any one-time payment made in connection with the alteration). Under the second safe harbor, the value equivalence requirement is satisfied if (1) the parties to the debt instrument or non-debt contract are not related and (2) through bona-fide, arm's-length negotiations over the alteration or modification, the parties determine that the fair market value of the altered instrument or contract is substantially equivalent to its fair market value before the alteration or modification.

In addition, to constitute a qualified rate, the replacement rate and the IBOR referenced in the replaced rate must be based on transactions conducted in the same currency (or be otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency).

Integrated transactions and hedges

Prop. Reg. Section 1.1001-6(c) states that a taxpayer is generally permitted to alter the terms of a debt instrument or modify one or more of the other components of an integrated or hedged transaction to replace a rate referencing an IBOR with a qualified rate without affecting the tax treatment of either the underlying transaction or the hedge (provided the modified transaction continues to qualify for integration).

Source and character of a one-time payment

Under Prop. Reg. Section 1.1001-6(d), the source and character of a one-time payment that is made in connection with an alteration or modification described in Prop. Reg. Section 1.1001-6(a)(1), (2) or (3) would 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.

Section 860G — REMICs

Under Prop. Reg. Section 1.860G-1(e), an interest in a REMIC will retain its status as a regular interest despite certain alterations and contingencies related to IBOR transition. For purposes of determining whether the regular interest has fixed terms on the startup day, certain alterations would be disregarded, including replacing an IBOR-referencing rate with a qualified rate, using a qualified rate as a fallback to an IBOR-referencing rate, and other alterations described in Prop. Reg. Section 1.1001-6(a)(1) or (3). The proposed regulations also include certain additional disregarded contingencies affecting the payment of principal and interest that do not prevent an interest in a REMIC from being a regular interest.

Section 882 – Interest expense of a foreign corporation

The proposed regulations would amend Treas. Reg. Section 1.882-5(d)(5)(ii)(B) – which permits foreign banks to elect a rate referencing the 30-day LIBOR – to allow a foreign corporation that is a bank to compute interest expense attributable to excess US-connected liabilities using a yearly average SOFR.

Implications

Given the number of financial instruments that reference IBOR (almost $200 trillion reference USD LIBOR alone),[3] the demise of this benchmark will affect numerous taxpayers. To that end, the proposed regulations provide welcome guidance on one of the most pressing issues – whether the transition to a new interest rate benchmark will result in the realization of gain or loss on an IBOR-based instrument. Nonetheless, the proposed regulations leave many questions unanswered, including:

- *The treatment of the one-time payment to compensate the other party upon transition to new benchmark*. The proposed regulations do not address when the one-time payment is recognized in taxable income. Further, while the proposed regulations provide that the character of the payment is the same that would otherwise apply to a payment made by the payor with respect to the instrument, in the case of a debt instrument, it is not clear how this rule applies. Thus, for example, it is not clear whether the payment would be treated as interest or a non-interest loan fee (if paid by the borrower) or a reduction of interest (if paid by the lender).
- *The treatment of a modification between related parties where the fair market value requirement of the qualified rate definition is not met*. The proposed regulation appears to imply that the transaction would result in a modification that requires testing under the current rules for modifications, which, in the case of a debt instrument, is Treas. Reg. Section 1.1001-3. Alternatively, general common law or regulations under Section 482 could deem a payment to satisfy the qualified rate definition to ensure that the related parties are acting at arm's-length. Such deemed payment could then give rise to other tax consequences.
- *Continued qualification for integrated transaction treatment*. In the case where the taxpayer has elected to integrate a debt instrument and another financial instrument under Treas. Reg. Section 1275-6 or 1.988-6 to qualify for integrated transaction treatment, it is unclear whether the instruments need to transition to the new benchmark on the same day to maintain integration. Further, guidance as to demonstrating that the modified integrated transaction continues to qualify for integration following the rate transition is needed. For example, such guidance could clarify whether certain contingencies that were initially disregarded as remote when the debt was originally issued should continue to be disregarded or must be re-tested for remoteness to conclude that the instruments continue to qualify for integrated treatment.

Hopefully, the final regulations will shed some light on each of these issues. In the meantime, because the transition from IBOR may impact debt instruments, as well many non-debt instruments that reference IBOR (including interest rate swaps, cross-currency swaps and equity swaps) taxpayers need to begin identifying their IBOR-based instruments. Once those transactions are identified, taxpayers will need to consider how they will transition those instruments from IBOR and how such transition will be treated under the proposed regulations, including any impacts to GAAP accounting for the tax consequences under ASC 740.[4]

Endnotes

1. ARRC is composed of representatives of private-sector entities with an important presence in markets affected by the transition from USD LIBOR and members from various US federal agencies.
2. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
3. Most floating rate debt instruments, including virtually all syndicated bank debt in the US carry an interest rate that references an IBOR (e.g., 3-month LIBOR plus a fixed margin).
4. For a discussion regarding certain US GAAP accounting rules impacted by the transition from LIBOR, see *EY To The Point No. 2019-26 (Sept. 6, 2019)*.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax Services – Capital Markets Tax Practice

- Tyler Arbogast, *Washington, DC* tyler.arbogast@ey.com
- David Golden, *Washington, DC* david.golden@ey.com
- Lena Y. Hines, *Los Angeles* lena.hines@ey.com
- Lee Holt, *New York* lee.holt@ey.com
- David Peppelman, *Washington, DC* david.peppelman@ey.com
- Michael Yaghmour, *Washington, DC* michael.yaghmour@ey.com

Ernst & Young LLP, Wealth and Asset Management

- Joseph Bianco, *New York* joseph.bianco@ey.com
- Gerald Whelan, *New York* gerald.whelan@ey.com
- Julie Valeant, *New York* julie.valeant@ey.com

Ernst & Young LLP, Financial Services Office

- Jack Burns, *New York* k.burns@ey.com
- Mark Kendall, *New York* mark.kendall@ey.com

International Tax and Transaction Services

Global ITTS Leader, **Jeffrey Michalak,** *Detroit*

ITTS Director, Americas, **Craig Hillier,** *Boston*

ITTS Markets Leader, Americas, **Laynie Pavio,** *San Jose, CA*

ITTS NTD Leader, **Jose Murillo,** *Washington, DC*

ITTS Regional Contacts, Ernst & Young LLP (US)

West
Sadler Nelson, *San Jose*

East
Colleen O'Neill, *New York*

Central
Aaron Topol, *Atlanta*

Financial Services
Chris J Housman, *New York*

Canada - Ernst & Young LLP (Canada)
Warren Pashkowich, *Calgary*

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