In July 2017, the U.K. Financial Conduct Authority—the regulator of the London Interbank Offered Rate (LIBOR)—announced that all currency and term variants of LIBOR (IBORs) will likely be phased out after 2021. In anticipation of LIBOR’s phase-out, the U.S. Treasury Department and Internal Revenue Service released proposed rules (the Proposed IBOR Regulations) in October 2019 to address the tax treatment of alterations made to instruments to replace an IBOR-based rate with an alternative rate. This article examines the Proposed IBOR Regulations.

The end of LIBOR

Proposed Treasury regulations address tax issues arising from LIBOR’s cessation

In the United States, the Alternative Reference Rates Committee (the ARRC) was convened to identify potential alternative benchmark rates. In March 2018, the ARRC selected the Secured Overnight Financing Rate (SOFR) as the replacement for USD LIBOR. Although SOFR is calculated from overnight transactions, term rates based on SOFR derivatives may be added in the future. Other jurisdictions also formed their own working groups and selected their own alternative rates. For example:

- The United Kingdom chose the Sterling Overnight Index Average (SONIA) to replace British pound sterling LIBOR.
- Japan chose the Tokyo Overnight Average Rate (TONAR) to replace yen LIBOR.
- Switzerland chose the Swiss Average Rate Overnight (SARON) to replace Swiss franc LIBOR.

What to keep in mind—tax issues arising from LIBOR’s end

LIBOR’s likely phase-out will mean that existing debt instruments and non-debt contracts (collectively referred to as instruments in this article) that currently reference LIBOR may need to be altered to reference a new rate. These alterations will likely be one of two kinds:

- Replacing the current IBOR rate with an alternative rate (e.g., replacing three-month LIBOR with a rate based on SOFR)
- Adding or altering a fallback provision to handle the eventual future transition to an alternative rate (e.g., a provision stating the alternative rate that will apply to the instrument once the current IBOR rate becomes unavailable).

Alterations such as these raise a number of tax questions, the primary one is whether the alterations are treated as a taxable event. At a high level, certain alterations can result in the parties to the instrument realizing gain or loss because, for tax purposes, the alteration is treated as an exchange of one piece of property (i.e., the unaltered instrument) for another, materially different piece of property (i.e., the altered instrument).
Under Treasury’s proposed rules and subject to certain requirements, such alterations generally do not cause a taxable event to the instrument. The following is an overview of those requirements:

— **Qualified rate:** The new rate must be a “qualified rate”—a rate that is a specified rate and that satisfies a fair market value (FMV) requirement:
  
  — **Specified rates:** The specified rates are generally any of the following:
    
    » For a specified currency, the replacement rate selected by the jurisdiction’s alternative rate working group (e.g., SOFR for USD)
    
    » Some other alternative rate selected, endorsed, or recommended by the relevant monetary authority or working group
    
    » Any variable rate if the variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the instrument is denominated in
    
    » A rate subsequently identified by the IRS.
  
  — **FMV requirement:** The FMV of the instrument after the alteration must be substantially equivalent to the FMV of the instrument before the alteration. The parties may use any reasonable, consistently applied valuation method and must take into account the value of any one-time payment made in connection with the change to a qualified rate. A reasonable method may (but need not) be based on past or projected values of the relevant rates. The safe harbors for satisfying the FMV requirement are discussed below.

— **Associated alterations:** Other alterations reasonably necessary to implement the rate change are permitted. These alterations may be technical, administrative, or operational (e.g., a change to the interest period or the timing and frequency of determining the rate or making payments of interest). Associated alterations include where one party must make a one-time payment to the other party in connection with the rate change.

— **Other contemporaneous alterations:** The proposed regulations provide no relief for any other alterations made contemporaneously with the rate-change alteration and any associated alterations. Contemporaneous alterations not covered under the proposed rules will be tested under the existing rules for determining whether the alteration causes a taxable exchange. For example, an alteration that addresses a change in a borrower’s credit since its debt instrument was originally issued would be tested under the existing rules for alterations to debt instruments.

— **Safe harbors of the FMV requirement:** As noted earlier, the FMV requirement requires that the values of the pre-alteration instrument and the post-alteration instrument be substantially equivalent. However, the FMV requirement is satisfied if one of the below safe harbors is met:

  — **Historic averages:** The FMV requirement is satisfied if, at the time of the alteration, the historic average of the IBOR rate is within 0.25% of the historic average of the new rate. The parties may use any reasonable method to compute the historic average, subject to two limitations: (1) The lookback period from which the historic data are drawn must begin no earlier than ten years before the alteration and end no earlier than three months before the alteration, and (2) the historic average must take into account every instance of the relevant rate published during the lookback period. Alternatively, the parties may compute the historic average of a rate in accordance with an industry-wide standard, such as a standard for determining an historic average set forth by ISDA or the ARRC for this or a similar purpose. The parties must use the same methodology and lookback period to compute the historic average for each of the rates to be compared.

  — **Arm’s-length negotiations:** The FMV requirement is also satisfied if the parties are not related and, through bona-fide, arm’s-length negotiations, determine that the FMV of the altered instrument is substantially equivalent to the FMV before the alteration.
Other topics addressed by the proposed IBOR regulations

- **Source and character of one-time payments:** The source and character of a one-time payment made in connection with the rate-changing alteration will be the same as the source and character that would otherwise apply to a payment made by the payor on the instrument. Consequently, if contractual payments on an instrument are not subject to U.S. tax if received by a foreign person, a one-time payment made in connection with the rate change is also likely not subject to U.S. tax.

- **Rules addressing how a rate-change alteration will affect the following issues:**
  - Hedges (Treas. Reg. section 1.446-4) and integrated transactions (Treas. Reg. sections 1.148-4(h), 1.988-5, and 1.1275-6)
  - Certain grandfathered instruments
  - OID rules and qualified floating rates
  - REMICs
  - The determination of allocable interest expense to the U.S. branch of a foreign bank.

- **Proposed applicability dates and reliance on the Proposed IBOR Regulations:** The Proposed IBOR Regulations apply after the date they are published as final regulations. However, a taxpayer can apply them to alterations that occur before that date, provided that the taxpayer consistently applies the rules before that date.

Initial observations

Market participants should welcome the Proposed IBOR Regulations. If the only change to an instrument is to replace the current IBOR Rate with SOFR or another replacement rate (or add fallback language to transition to a replacement rate), we expect limited tax consequences to the instrument’s parties. However, the parties will still need to confirm that the transition satisfies the requirements discussed above.

Even though the LIBOR phase-out potentially affects any lender or borrower, financial institutions will perhaps be most affected. They must begin to modify existing instruments to take into account a replacement rate, and controls may need to be developed to determine whether other contemporaneous alterations are made to the instrument (e.g., an extension of the maturity date or changes to the interest rate because of changes in creditworthiness). Whether these alterations result in a taxable exchange will be determined under existing rules.

As instruments are modified to take into account a replacement rate, lending institutions will begin to receive questions from customers with regards to the tax implications of the modification. Employees may need to be educated on how they should address these questions.

Satisfying the FMV requirement, for financial transactions with either related or unrelated parties, may present its own challenges. Replacement rates such as SOFR, for instance, may currently lack a term structure that could be used to calculate FMV post alteration. Consequently, it may not be a straightforward matter to settle on a reasonable valuation method, and there is the potential for tax authority disputes, particularly if the alteration is examined years down the road, when more comprehensive SOFR data is available due to expanded market liquidity. Lack of a term structure can also impair the ability to price instruments with varying interest reset periods.

The FMV safe harbor provisions can alleviate some of these challenges, but may also be affected by data issues in that there is a limited history available for some replacement rates. Additional complications are introduced for financial instruments which may have had previous amendments or contractual modifications that changed the reference rate or spread. It is unclear how the safe harbor, particularly for related-party instruments, would be applied in practice.

Finally, these rules only address the U.S. tax implications of the transition away from IBOR rates. Market participants that are subject to tax in other jurisdictions must continue to monitor how those non-U.S. tax jurisdictions intend to address the transition.

Conclusion

The Proposed IBOR Regulations generally allow taxpayers to change from LIBOR to a qualified rate without causing a taxable event to the underlying instrument. But as can be seen above, care must be taken to meet the various requirements.

KPMG LLP looks forward to assisting you in the transition as the era of LIBOR ends. No matter what transition strategy you apply, we can guide you in supporting, operationalizing, and documenting changes to your financial instruments.
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