SULLIVAN & CROMWELL LLP

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Treasury and IRS Release Proposed Regulations on Transition From Interbank Offered Rates to Other Reference Rates

The Proposed Regulations Provide Guidance on the Tax Consequences of the Transition to the Use of Reference Rates Other Than Interbank Offered Rates in Debt Instruments and Non-Debt Contracts

SUMMARY

The Treasury Department and IRS recently released proposed regulations (the "Proposed Regulations") under the U.S. Internal Revenue Code (the "Code") that, if finalized, would provide guidance on the tax consequences of the transition from Interbank Offered Rates (IBORs) to other reference rates in debt instruments and non-debt contracts. The replacement of an IBOR with a new reference rate in a financial instrument could result in the realization of income, deduction, gain or loss for federal income tax purposes. The Proposed Regulations are intended to reduce the tax costs and uncertainties associated with the transition to other reference rates.

BACKGROUND

In 2017, the U.K. Financial Conduct Authority, the regulator overseeing LIBOR, announced that all currency and term variants of LIBOR, including USD LIBOR, may be phased out after 2021. In light of the prevalence of USD LIBOR as the reference rate in a vast range of financial instruments, the Alternative Reference Rates Committee (ARRC) was convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York to identify an alternative rate. The ARRC recommended the Secured Overnight Financing Rate (SOFR), an overnight, nearly risk-free rate, as the replacement rate for USD LIBOR. Financial instruments that currently rely on IBORs are expected to transition to SOFR or similar alternatives in the next few years. The Treasury Department and IRS issued the Proposed Regulations to address the ARRC's request for guidance to address potential tax issues associated with the transition to alternative interest rates.

THE PROPOSED REGULATIONS

A. SECTION 1001 DEEMED EXCHANGE

Section 1001 of the Code and the regulations thereunder provide that gain or loss is recognized upon the exchange of property for other property differing materially either in kind or in extent. Certain modifications of debt instruments and non-debt contracts are treated as deemed exchanges resulting in recognition of gain or loss for tax purposes. The Proposed Regulations provide that alterations to the terms of a debt instrument or a non-debt contract to replace an IBOR-referencing rate with a "qualified rate" (as defined below) would not result in a recognition event for tax purposes. Similarly, an alteration of a debt instrument or non-debt contract to provide a qualified rate as a fallback to an IBOR-referencing rate or to replace an IBOR-referencing fallback rate with a qualified rate would not result in a recognition event for tax purposes. The Proposed Regulations also include a coordination rule to ensure that any other contemporaneous alterations would be analyzed under the existing deemed exchange rules, with the qualifying alterations described above becoming part of the baseline against which the other contemporaneous alterations are tested.

The Proposed Regulations set forth a list of reference rates which would be qualified rates provided that the following requirements are met: (i) the fair market value of the instrument after the relevant alteration is substantially equivalent to the fair market value of the instrument prior to the relevant alteration (the "value equivalence requirement") and (ii) the benchmark rate included in the replacement rate and the IBOR referenced in the replaced rate 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 (the "currency requirement").[1]

The Proposed Regulations include two safe harbors under which the value equivalence requirement will be satisfied: (i) the historic average of the IBOR-referencing rate is within 25 basis points of the historic average of the replacement rate or (ii) the parties to the instrument are unrelated and, through arm's-length negotiations, determine that the fair market values of the two rates are substantially equivalent (taking into

[1] The Proposed Regulations identify as qualified rates the following specific rates (provided that the value equivalence requirement and the currency requirement are met): the Secured Overnight Financing Rate published by the Federal Reserve Bank of New York (SOFR); the Sterling Overnight Index Average (SONIA); the Tokyo Overnight Average Rate (TONAR or TONA); the Swiss Average Rate Overnight (SARON); the Canadian Overnight Repo Rate Average (CORRA); the Hong Kong Dollar Overnight Index (HONIA); the interbank overnight cash rate administered by the Reserve Bank of Australia (RBA Cash Rate); the euro short-term rate administered by the European Central Bank (€STR); any alternative, substitute or successor 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 an IBOR or its local currency equivalent in that jurisdiction; and any rate that is a "qualified floating rate" for tax purposes (or a multiple thereof).

account the value of any one-time payment or adjustment to the interest rate spread in connection with the change in interest rate).

Under the Proposed Regulations, a one-time payment between the parties to a debt instrument or non-debt contract to offset any differences between an IBOR-referencing rate and a replacement "qualified rate" would not trigger a deemed disposition of the instrument or contract for tax purposes. The Proposed Regulations would clarify that such a one-time payment has the same source and character as other payments made with respect to the instrument by the payor of the one-time payment. However, the Treasury Department and IRS request comments with respect to the source and character of payments received by a party that does not ordinarily receive payments (e.g., payments made by the lender to the borrower). The Proposed Regulations do not address the timing of any deduction or income inclusion with respect to such a payment.

The Proposed Regulations further:

- provide that alterations to the terms of a component of an integrated or hedged transaction to replace an IBOR-referencing rate with a qualified rate would not affect the tax treatment of the underlying transaction or the hedge, provided that the modified transaction continues to qualify for integration;
- provide that a "regular interest" in a real estate mortgage investment conduit (REMIC) would retain its status despite a change from an IBOR-referencing rate to a qualified rate;
- provide that a debt instrument that provides for an IBOR-referencing rate followed by a possible qualified rate will be treated as having a single floating rate for purposes of determining whether the instrument has original issue discount; and
- amend the Section 882 regulations, which provide that a non-U.S. corporation that is a bank may elect a rate that references 30-day LIBOR to calculate interest expense allocable to excess U.S.-connected liabilities, to allow the use of the yearly average SOFR instead.[2]

B. GRANDFATHERED INSTRUMENTS

The preamble to the Proposed Regulations clarifies that certain "grandfathered" instruments, such as debt instruments and non-debt contracts that are grandfathered under Sections 163(f), 871(m) or 1471 of the Code, are not treated as reissued as a consequence of an alteration that replaces an IBOR-referencing rate with a qualified rate.

C. EFFECTIVE DATE AND REQUEST FOR COMMENTS

If finalized, the Proposed Regulations would generally apply to an alteration or modification of a debt instrument or a non-debt financial contract (or, in the case of the OID rules or the REMIC rules, to an issuance of a debt instrument or an issuance of a regular interest in a REMIC, respectively) that occurs on

[2] The Treasury Department and IRS request comments on whether another rate might be more appropriate for this purpose, given that SOFR does not reflect credit risk and is likely to be lower than 30-day LIBOR.

or after the date of publication of the Treasury decision adopting the Proposed Regulations as final regulations in the Federal Register. However, a taxpayer may choose to apply the Proposed Regulations to alterations, modifications or issuances that occur before that date, provided that the rules are consistently applied.

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