

HAWKINS ADVISORY

Proposed Treasury Regulations and Other Regulatory Initiatives in Connection with the USD LIBOR Phase-Out

I. Background

On July 27, 2017, the United Kingdom's Financial Conduct Authority (the "FCA"), the regulator responsible for overseeing the production of London interbank offered rate ("LIBOR"), announced that it intended to stop its current efforts to assure sufficient bank participation in LIBOR rate-setting to permit continued publication of LIBOR rates as representative rates for regulatory purposes as of the end of 2021. Since then, organizations representing different market sectors have been advocating for guidance in addressing the various federal tax implications resulting from the need to amend existing documents to provide for alternative reference rates for the purpose of replacing LIBOR and other interbank offered rates ("IBORs").

The FCA's announcement may be viewed as part of a coordinated effort by capital market regulators over the past decade to effect a transition from broad transactional reliance upon IBORs (which are generally based on panel banks' estimates of inter-bank loan market rates, as applicable to various currencies and borrowing terms), to instead utilize more transparent reference rates based upon actual transactions in more robust markets.¹

In the United States, preparations for the phase-out of IBOR reliance have been led by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York (the "NY Fed"). The NY Fed has undertaken responsibility to produce an alternative reference rate based upon its observations of overnight United States Treasuries repurchase agreements (the "Secured Overnight Financing Rate" or "SOFR") and began daily publication of SOFR on April 3, 2018. In addition, the NY Fed convened the Alternative Reference Rates Committee ("ARRC"), which includes a broad cross-section of capital market participants, to address implementation issues, including the amendment of the documentation for existing transactions that rely on IBORs. Implementation issues relating to derivatives are also being addressed by the International Swap Dealers Association ("ISDA"), the Commodity Futures Trading Commission ("CFTC") and the Government Accounting Standards Board ("GASB"). Other implementation issues are being addressed by the

Department of the Treasury ("Treasury") and the Securities and Exchange Commission ("SEC"). This Hawkins Advisory reviews recently released Proposed Treasury Regulations and summarizes the current status of the rest of this regulatory work.

II. The Proposed Treasury Regulations

The ARRC identified certain tax issues associated with the elimination of IBORs and requested guidance from Treasury and the IRS to address those issues and to facilitate an orderly transition to new reference rates. The tax issues raised by ARRC, as they relate to tax-advantaged obligations and qualified hedges of such obligations, are as follows:

- Reissuance concerns in connection with amendments to documents to reflect a new reference rate or a new fallback provision.²
- Qualified floating rate and original issue discount concerns resulting from a new reference rate that may require (a) adjustments to the spread above the base reference rate in order to account for the expected differences between the two base reference rates (generally representing term premium and credit risk), and/or (b) a one time, lump-sum payment in lieu of a spread adjustment.

In response, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") issued proposed regulations that were published in the Federal Register on October 9, 2019 (the "Proposed Regulations").³

The Proposed Regulations generally provide that changes to existing debt instruments and to other contracts, including derivatives that are treated as qualified hedges for debt instruments, made to replace an IBOR-based reference rate with a "qualified rate" will not be considered a material modification for purposes of §1001 of the Internal Revenue Code, as amended (the "Code") and therefore will not result in an exchange of the instrument for federal tax purposes, whether the change takes the form of an amendment to existing documents or

¹ Concerns relative to the adequacy and integrity of IBOR rate-setting and other considerations were reviewed by the Financial Stability Board in its *Report on Reforming Major Interest Rate Benchmarks* (https://www.fsb.org/wp-content/uploads/r_140722.pdf; July 2014). Responses have generally attempted to conform to the International Organization of Securities Commissions Organization's *Principles for Financial Benchmarks*, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf>, July 2013.

² Fallback provisions are provisions specifying how a variable rate of interest is to be determined if the then applicable reference rate becomes unavailable or is otherwise judged to have deteriorated to an extent that it is no longer a suitable benchmark rate.

³ <https://www.federalregister.gov/d/2019-22042>

a substitution of documents. This guidance is incorporated into new §1.1001-6 of the Treasury Regulations.⁴

A. In General – The Instrument Will Not Be Considered “Substantially Modified”⁵

An alteration to an existing debt instrument, derivative, or other contract that either (a) directly replaces an IBOR-based reference rate with a “qualified rate” or (b) adds or amends a fallback provision to reference a “qualified rate,” will not be treated as an exchange under §1001, provided the fair market value of the instrument after the alteration is substantially equivalent to the fair market value of the instrument before the alteration and that there is no change to the transaction currency. The same rule applies to “associated alterations,” which are alterations that are both associated with the replacement of an IBOR-based reference rate and reasonably necessary to adopt or implement that replacement. Such associated alterations may be technical, administrative or operational in nature and may include necessary adjustments to the frequency and timing of rate-setting, as well as spread adjustments and/or one-time payments attributable to the difference in value between the IBOR-based rate and the alternative reference rate, but not ones that are attributable to a party’s current credit.

B. Qualified Rate Defined

A “qualified rate” consists of one of the following:

(1) SOFR;⁶

(2) 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;

(3) Any qualified floating rate, as defined in §1.1275-5(b) (but without regard to the limitations on multiples set forth in §1.1275-5(b)), that is not described in (1) (including in the accompanying footnote) or (2) above;

(4) Any rate that is determined by reference to a rate described in (1), (2) or (3) above, including a rate determined by adding or subtracting a specified number of basis points to or from the rate or by multiplying the rate by a specified number; or

(5) Any rate identified as a qualified rate in supplemental guidance published in the Internal Revenue Bulletin for purposes of §1.1001-6.

C. Alteration Must Result in Fair Market Value

The Proposed Regulations further provide that an alternate reference rate will be considered a “qualified rate” only if the fair market value of the instrument after the alteration is substantially equivalent to the fair market value of the instrument before the alteration. Fair market value, for this purpose, may be determined using any reasonable, consistently applied valuation method and must take into account the value of any one time payment that is made in connection with the alteration. The Proposed Regulations offer two safe harbors for purposes of determining fair market value, as well as the possibility of additional guidance in this area.

(1) Safe Harbors for Projecting Values to Compare Fair Market Value of the New Rate

(a) Historic Average of Rates. On the date of alteration, the historic average of the relevant IBOR-based reference 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.

For this purpose, an historic average may be determined by using an industry-wide standard, such as a method of determining an historic average recommended by the IDSA for the purpose of computing the spread adjustment on a rate included as a fallback to an IBOR-based reference rate on a derivative or a method of determining an historic average recommended by the ARRC for the purpose of computing the spread adjustment for a rate that replaces an IBOR-based reference rate on an instrument.

An 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 and ending no earlier than three months before the alteration. No minimum period corresponding to the rate setting period is included in this provision.

For purposes of this safe harbor, the historic average must be determined for both rates using the same method and historical data from the same timeframes and must be determined in good faith by the parties with the goal of making the fair market value of the instrument after the alteration

⁴ This Advisory primarily addresses debt instruments and related derivatives. The Proposed Regulations provide guidance in respect of other instruments as well.

⁵ The Proposed Regulations use the terms “alteration or modification” throughout; except for this heading, the Advisory uses “alteration” for purposes of describing a “change”.

⁶ In connection with instruments denominated in currencies other than the US dollar, the Proposed Regulations also identify as “qualified rates” each of: the Sterling Overnight Index Average; the Tokyo Overnight Average Rate; the Swiss Average Rate Overnight; the Canadian Overnight Repo Rate Average; the Hong Kong Dollar Overnight Index; the interbank overnight cash rate administered by the Reserve Bank of Australia; and the euro short-term rate administered by the European Central Bank.

substantially equivalent to the fair market value of the instrument before the alteration.

(b) Arm's Length Negotiations. The parties to the instrument are not related (within the meaning of §267(b) or §707(b)(1)) and the parties determine, based on bona fide, arm's length negotiations between the parties, that the fair market value of the instrument before the alteration is substantially equivalent to the fair market value after the alteration. For this purpose, the fair market value of the instrument after the alteration must take into account the value of any one-time payment that is made in connection with the alteration.

(2) Currency of the Interest Rate Benchmark

The Proposed Regulations further mandate that a rate is a qualified rate only if the interest rate benchmark to which the rate refers after the alteration and the IBOR to which the instrument referred before that alteration 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.

D. Other Contemporaneous Changes

Any other alteration of an instrument that is contemporaneous with a change to an existing IBOR-based reference rate, including in respect of a fallback provision and associated alterations, as described above, is required to be analyzed independently from the changes addressed by the Proposed Regulations for purposes of determining whether an instrument has been reissued under §1001. For this purpose, the alternative reference rate alteration and any associated alteration is treated as part of the existing terms of the instrument and becomes part of the baseline against which the non-alternative reference rate alteration is tested under the general reissuance rules.

E. Reissuance Concerns in Connection with Qualified Hedges

Rules similar to the foregoing apply under the Proposed Regulations to qualified hedges under §1.148-4(h) of the Treasury Regulations. An alteration to replace an interest rate referencing an IBOR with a qualified rate on a hedging transaction for bonds that is integrated as a qualified hedge under §1.148-4(h) for purposes of the arbitrage investment restrictions applicable to state and local tax-exempt bonds and other tax advantaged bonds (as defined in §1.150-1(b)) is not treated as a termination of that qualified hedge under §1.148-4(h)(3)(iv)(B), provided that the hedge as altered continues to meet the requirements for a qualified hedge under §1.148-4(h), as determined by applying the special rules for certain alterations of qualified hedges under §1.148-4(h)(3)(iv)(C).

F. Source and Character of a One-Time Payment

For all purposes of the Code, the source and character of a one-time payment that is made by a payor in connection with the alteration is the same as the source and character that would otherwise apply to a payment made by the payor with respect to the instrument that is altered.

G. Coordination with the OID Rules in Respect of Certain Variable Rate Debt Instruments

The Proposed Regulations also include Treasury Regulation §1.1275-2(m), which addresses questions regarding original issue discount ("OID") on certain variable rate debt instruments ("VRDIs") that are amended to provide for an alternative reference rate, including amendments to a fallback rate.

A variable rate is generally a "qualified floating rate" if variations on the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. If a debt instrument provides for two or more qualified floating rates that can reasonably be expected to have approximately the same values throughout the term of the instrument, the qualified floating rates together constitute a single qualified floating rate.

The current Treasury Regulations include provisions addressing debt instruments which include one or more payments that are subject to a contingency; such instruments are referred to as "contingent payment debt instruments" or "CPDI". The Treasury Regulations impose a complex set of rules governing the timing and characterization of debt service payments made in respect of CPDI if the contingency occasioning the payment is not a "remote" contingency. The Treasury Regulations also provide that even if the contingency is "remote", and the complex rules do not apply, the debt instrument will nevertheless be treated as retired and reissued if there is a "change in circumstances" triggering the remote contingency.

The Proposed Regulations provide relief from the contingent interest rules in the case of variable rate instruments that provide both for a qualified floating rate that references an IBOR and for a methodology to change the IBOR-based reference rate to a different rate in anticipation of the IBOR-based reference rate becoming unavailable or unreliable, as follows:

1. Single qualified floating rate. The IBOR-based reference rate and the alternative reference rate are treated as a single qualified floating rate for purposes of §1.1275-5.

2. Remote contingency. The possibility that the IBOR will become unavailable or unreliable is treated as a remote contingency.
3. Change in circumstances. The fact that the IBOR has become unavailable or unreliable is not treated as a change in circumstances for purposes of treating an instrument that is subject to a remote contingency, as described above, as reissued.

Current Treasury Regulations establish that a rate is a qualified floating rate, unless the rate is subject to a multiplier, except for multipliers that fall within certain parameters (generally, more than 0.65 and less than 1.35); these parameters are specifically waived under the qualified rate provisions.

A tax-exempt CPDI that contemplates a contingent payment based upon a multiplier that is less than 0.65 is currently addressed in §1.1275-4(d)(2); such an instrument will not generally be subject to the complex contingent interest payment rules. It should be noted that future proposed regulations might also address the implications of different adjustments that may be necessary in order to comply with the fair market value requirement of a qualified rate as it relates to the current definition of a VRDI.

H. Effective Dates and Comment Period

The provisions of Proposed Regulations §1.1001-6 and §1.1275-2(m) apply to an alteration of the terms of an instrument that occurs on or after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. Taxpayers and their related parties may apply these sections to alterations that occur before such publication date of final regulations provided that the taxpayers and their related parties consistently apply these rules before that date. The comment period for the Proposed Regulations expires on November 23, 2019.

III. Status of Other Regulatory Preparations

The Proposed Regulations that are discussed above are but one of a number of developments over the past months that have begun to substantially clarify the regulatory and market practice contexts in which individual market participants may expect to address a transition of their financing transactions from LIBOR reliance to alternative reference rates. With approximately 26 months remaining until the projected end of LIBOR production as a regulator-sponsored reference rate, this clarity will permit participants to begin to take some concrete preparatory steps.

Industry working groups convened by the ARRC have completed several sector-specific consultation processes

that have resulted in recommendations for more robust fallback language to be used in new transactions referencing LIBOR in response to the increased probability that its utility as a reference rate deteriorates. To date, this process has resulted in separate recommendations for use in floating rate notes⁷ and in securitizations⁸, in two alternate recommendations for use in syndicated bank loans⁹, and in three for use in bilateral business loans¹⁰. These recommendations vary between sectors as to the nature of triggering events, the process for determining a replacement reference rate and adjustment factors to be applied to the replacement rate and the relative duties and notice and consent rights of transaction parties, as well as in the degree of anticipated optionality in incorporating recommendations into transaction documents. Differences in structural facts affecting different capital market sectors make divergence in practice inevitable and both regulators and market participants with exposure to LIBOR in multiple sectors will need to accommodate these differences. Each of the Proposed Regulations described above and the ISDA consultations and GASB exposure draft statement described below contemplate that more robust fallback language will also be introduced to existing transaction documents.

On September 19, 2019, ARRC published its *Practical Implementation Checklist for SOFR Adoption*¹¹ for banking institutions with USD LIBOR exposure, noting regulator statements that: (i) “the discontinuance of LIBOR is a certainty”; and (ii) “market participants should take appropriate action to transition from LIBOR to an alternative risk free rate.”

ISDA has also initiated industry consultation processes concerning benchmark fallback provisions, disclosure, pre-cessation and reference rate adjustment issues in preparation for promulgation of amendments to the ISDA Definitions and of a Protocol for amending existing derivatives contracts.¹² On September 9, 2019, the CFTC Market Risk Advisory Committee published draft “Plain English” disclosures for new derivatives addressing the status of LIBOR and of the ISDA’s response, pending final CFTC approval.¹³ It should be noted that several of

⁷ https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN_Fallback_Language.pdf

⁸ https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization_Fallback_Language.pdf

⁹ https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Syndicated_Loan_Fallback_Language.pdf

¹⁰ https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Bilateral_Business_Loans_Fallback.pdf

¹¹ <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-Checklist-20190919.pdf>

¹² <https://isda.org/category/legal/benchmarks>

¹³ https://www.cftc.gov/media/2491/MRAC_IBORDisclosures090919/download

the ARRC working group recommendations refer to expected ISDA reference rate or methodology recommendations.

The SEC published on July 12, 2019 a multi-Division Staff *Statement on LIBOR Transition* (the “SEC Statement”¹⁴, encouraging market participants to determine their post-2021 exposure to LIBOR in a broad sense that would include business conditions and business model considerations. The SEC Statement also articulated general baseline disclosure and, for regulated entities, diligence expectations. These suggest that market participants should consider the exposure and transition plans of their counterparties as well as their own direct exposure. In this connection, the Division of Investment Management expressly encouraged funds and advisors to consider the need to disclose to investors risks that may result from the discontinuation of LIBOR and to provide investors with tailored, rather than generic, disclosure.

On September 16, 2019, GASB released an exposure draft of a Proposed Statement *Replacement of Interbank Offered Rates*¹⁵ that would: (i) remove LIBOR as an appropriate benchmark interest rate for hedge accounting purposes, with respect to derivative instruments hedging the interest rate risk of taxable debt, effective with respect to accounting periods beginning after December 15, 2020; (ii) add SOFR as an appropriate benchmark interest rate for such purposes, effective with respect to accounting periods beginning after June 15, 2020; and (iii) for hedged items and leases, permit a direct replacement of a reference rate

or the addition or amendment of a fallback provision (with necessary adjustments to equate the replacement rate with the original one) without requiring hedge termination or lease modification, also effective with respect to accounting periods beginning after June 15, 2020. The comment period with respect to the exposure draft extends through November 27, 2019.

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¹⁴ <https://www.sec.gov/news/public-statement/libor-transition>

¹⁵ https://www.gasb.org/jsp/GASB/Document_C/DocumentPage&cid=1176173506340

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