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April 8, 2019

Re: U.S. Federal Income Tax Issues Relating to the Transition from IBORs to RFRs

Ladies and Gentlemen:

The Alternative Reference Rates Committee ("ARRC"), a committee convened by the Board of Governors of the Federal Reserve and by the Federal Reserve Bank of New York with the support of a number of agencies including the U.S. Department of the Treasury, is writing to request guidance regarding tax issues that arise as result of the market transition from the London Interbank Offered Rate ("LIBOR") and other Interbank Offered Rates ("IBORs") to alternative risk-free rate benchmarks ("RFRs").

For the reasons discussed below, timely guidance on these topics is critical to a successful transition of a very large number of existing IBOR-based contracts to the replacement RFRs. Although LIBOR may be available until the end of 2021, industry organizations, other regulators, and market participants are working to facilitate earlier modifications of both

contractual “fallback” provisions as well as actual rates referenced in debt and other contracts, and significant activity in furtherance of these goals is likely to begin as early as fall 2019. The ARRC believes that such early modifications will help ensure an orderly market transition away from IBORs, and therefore any significant tax barriers to completing them should be addressed as promptly as possible.

I. Introduction

Background and Developments Regarding IBOR Transition

In response to concerns regarding the reliability and robustness of LIBOR and other IBORs, the Financial Stability Board and the U.S. Financial Stability Oversight Council have called for the identification of risk free alternatives to LIBOR and transition plans to support implementation of identified alternatives. In response, central banks in various jurisdictions, including the United States, the United Kingdom, Japan, Switzerland and the Eurozone, have convened working groups of market participants and government representatives.

In 2014, the Federal Reserve Bank of New York convened the ARRC in order to identify best practices for U.S. alternative reference rates and contract robustness, select the new reference rate that would be available to market participants to replace USD LIBOR, develop frameworks for migrating LIBOR-linked contracts to the new rate, and create an implementation plan with metrics of success and a timeline.

In June 2017, the ARRC identified a broad Treasury repo financing rate, *i.e.*, the Secured Overnight Financing Rate (“SOFR”), as the preferred alternative to U.S. Dollar (“USD”) LIBOR for certain new USD derivatives and other financial contracts.[1]

The transition to SOFR removes a source of risk and moves markets to a reference rate that is more firmly based on transactions from a robust underlying market and that complies with emerging standards, such as the Principles for Financial Benchmark adopted by the International Organization of Securities Commissions (“IOSCO”). The SOFR underlying market has significant volume, covering multiple segments of the Treasury repo market, the largest rates market in the world. Additionally, SOFR’s market is resilient, and even operated smoothly during the financial crisis.[2] As a result, market participants are confident in its long-run

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[1] *See* Alternative Reference Rates Committee, Press Release, June 22, 2017, available at https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf.

[2] The ARRC is aware of certain publicized concerns regarding the volatility of SOFR, and thus of SOFR’s viability as a replacement reference rate. However, while overnight repo rates are more volatile than term LIBOR rates on a day-to-day basis, contracts referencing SOFR would use an average of daily SOFR rates over a fixed period of time. For example, the floating rate on these instruments might be a 3-month compound average of daily SOFR rates. Such averages are much less volatile than the daily observations of SOFR and are typically only minimally impacted by any volatility on quarter ends. In fact, a 3-month average of SOFR is less volatile than 3-month LIBOR. *See* Alternative Reference Rates Committee Second Report, March 2018, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report. Thus, it is the

sustainability and ability to reduce risk for transactions with longer maturities.[3] While the ARRC is specifically focused on the transition from USD LIBOR to SOFR, taxpayers will have similar concerns with respect to the transition from IBORs to RFRs in other jurisdictions as well.

In July 2017, the U.K. Financial Conduct Authority ("FCA"), which regulates the ICE Benchmark Administration, the administrator of LIBOR, announced that it had sought commitments from LIBOR panel banks to continue to contribute to LIBOR through the end of 2021, but that the FCA will not use its powers to compel or persuade contributions beyond that date.

Since this announcement, market participants have been concerned with the availability of LIBOR and other IBORs after 2021. As a result, there has been an increased effort to reduce reliance on IBORs and ensure an orderly transition to RFRs. In connection with this transition, legal agreements that reference IBORs—both new and existing—will need to be modified in order to avoid unintended economic consequences. There is a broad range of products that reference IBORs today, such as over the counter and exchange traded derivatives, loans, both taxable and tax-exempt bonds, floating-rate notes and securitized products. Effort is ongoing to facilitate the modification of such products to reference RFRs—both through immediate replacement of the reference rate, and through amendment to provisions specifying what is to occur if an IBOR is permanently discontinued or is judged to have deteriorated to an extent that its relevance as a reliable benchmark has been significantly impaired ("fallback provisions"). While some agreements do not include fallback provisions, many existing agreements do contain them; however, historically, these provisions did not contemplate a permanent discontinuance of the referenced IBOR and were only intended to address temporary unavailability (for example, by providing that the last quoted rate should be used if no published rate is available). Because these fallback provisions are varied and in some cases provide for calculation agent discretion, if these contracts are not amended to incorporate more appropriate fallbacks, or to convert the reference rate from an IBOR to an RFR prior to the IBOR discontinuance, there is a risk of market divergence in their application and potential disputes as to their interpretation. As a result, financial institutions and other market participants may be exposed to the risk of mismatches between their hedged positions that currently reference LIBOR, which would adversely affect financial stability.

The International Swaps and Derivatives Association ("ISDA") is working to develop industry standard IBOR fallback provisions for derivatives and will offer a protocol (the "ISDA protocol") that will enable two parties to modify the fallback provisions in their legacy derivative contracts by adhering to the protocol.[4] The ARRC is simultaneously developing recommended fallback provisions for other financial instruments.[5] Some individual market participants are also incorporating their own IBOR fallback provisions into new agreements, the terms of which vary.

ARRC's expectation that the use of SOFR-based reference rates will not present volatility concerns incremental to those of LIBOR or other IBORs.

[3] Term wholesale unsecured borrowing, *i.e.*, the market underlying LIBOR, is substantially less frequent during periods of stress, particularly at longer maturities.

4 Information regarding ISDA's consultation on fallback provisions is available at https://www.isda.org/2018/12/20/isda-publishes-final-results-of-benchmark-fallback-consultation/.

5 The ARRC information page on fallback contract language can be found at https://www.newyorkfed.org/arrc/fallbacks-contract-language.

These recently developed fallback provisions generally provide that a calculation or similar agent will select an alternative reference rate and potentially a spread to the new rate, subject to certain conditions once certain triggers occur, with some requiring the consent of one or more parties to the agreement.

Anticipated Actions and Importance of Timely Guidance

The Financial Stability Oversight Counsel has encouraged private sector participants to incorporate more robust fallbacks into LIBOR-linked contracts and has recommended that member agencies identify and mitigate risks from potential dislocations during the transition process to SOFR. Because an estimated $200 trillion of outstanding contracts reference USD LIBOR,[6] the transition to SOFR will take some time, and it is therefore imperative to U.S. financial stability that the transition process make substantial progress well before the end of 2021, when it is anticipated that LIBOR will cease publication.

SOFR began publication roughly a year ago and SOFR-based markets are still developing; nonetheless, some market participants are already beginning to seek to transition from LIBOR and it is important that this be encouraged. About 95% of gross notional exposures to LIBOR are in derivatives contracts, and therefore widespread take-up of the ISDA protocol will have inordinate importance in mitigating financial stability risks. Currently, ISDA expects to consult market participants on fallback provisions for USD LIBOR and certain details of its fallback specifications during the first half of 2019, and to offer its protocol for signing by the end of 2019. Upon offering the protocol, ISDA will institute a 2-3 month period in which market participants may sign before the protocol will take effect. Early and widespread agreement to the ISDA protocol will mitigate financial stability risks and will encourage further adoption; however, widespread adoption will be difficult to achieve if adhering to the protocol potentially causes adverse tax consequences. Therefore, timely guidance this year on tax matters will play an important role in the ISDA protocol's success. The ARRC is seeking similar forms of regulatory relief from U.S. prudential and other market regulators as well as the Financial Accounting Standards Board this year for the same reason, and those authorities have signaled an understanding of the importance of such timely relief.

As noted above, the ARRC expects to recommend more robust fallback language for other financial instruments in the first half of 2019, and in some instances market participants may seek to incorporate these recommendations or other fallbacks into already existing contracts. It is also likely that more market participants will seek to amend contracts to move from LIBOR to SOFR or other RFRs this year, and timely guidance would serve to encourage this transition. Removing potential adverse tax consequences will promote confidence that regulatory bodies will mitigate risks, thereby promoting confidence that the transition can occur in a way that is orderly and safe.

Although market participants and regulatory authorities continue to evaluate and refine the details regarding the processes by which RFRs will replace IBORs in various categories of financial instruments, waiting to issue tax guidance until all details are worked out is inadvisable. Such a delay could jeopardize the success of the ISDA protocol and hinder the early conversion

6 See Alternative Reference Rates Committee Second Report, March 2018, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.

of IBOR contracts to RFRs, undermining the development of a robust market for contracts in those RFRs. Moreover, once other regulatory and technical issues regarding RFR conversions have been resolved, the conversion process will likely accelerate.

Summary of Requests for Guidance

The ARRC requests guidance on the following topics, as discussed in more detail in Parts II and III below. The ARRC would welcome such guidance in any form, for example*,* as a notice or proposed regulations, provided taxpayers may rely on it.

Part II – Section 1001 Considerations

1. The Internal Revenue Service (the "IRS") and Treasury should provide that a contractual modification that switches a financial instrument from referencing an IBOR to an RFR will not be a taxable event under Section 1001[7] with respect to a debt obligation or other financial instrument (including derivatives). In order to make the process straightforward, such guidance should be broad and flexible. Specifically, and as discussed in more detail below, the scope of this guidance should include: (1) modifications to fallback provisions as well as to the referenced rate; (2) IBORs in addition to USD LIBOR; (3) replacement rates that include SOFR, similar replacement rates for other IBORs, and potentially any qualified floating rate ("QFR")[8]; and (4) modifications where the change in reference rate or fallback provision is compensated through either spread adjustments or a one-time payment.

Part III – Additional Considerations

2. The IRS and Treasury should confirm that modifications to the reference rate, spread and related administrative provisions of a REMIC regular interest will not cause the regular interest to be treated as not having fixed terms on the REMIC's startup day.

3. The IRS and Treasury should clarify that an instrument that references an IBOR and a methodology designed to produce a fallback rate, such as SOFR or another QFR, that replaces the IBOR in circumstances in which the IBOR is no longer available or reliable is treated as referring to a single QFR for purposes of the Treasury regulations governing original issue discount ("OID") on variable rate debt instruments.

4. The IRS and Treasury should provide guidance that permits taxpayers to use an appropriate RFR in place of LIBOR in Section 1.882-5(d)(5)(ii)(B).

[7] Unless otherwise indicated, all "Code" or "Section" references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder (the "Treasury regulations" or "Treas. Regs.").
[8] QFR is defined in Treas. Reg. § 1.1275-5(b)(1) and means, generally, any rate if 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 debt instrument is denominated.

5. The IRS and Treasury should provide guidance confirming that the change of a discount rate used for purposes of Section 475 valuations of securities from an IBOR to another rate, either in anticipation of the discontinuation of such IBOR or at the time at which the IBOR no longer is available, does not constitute a change of accounting method.

II. Potential Taxable Exchange under Section 1001 and Related Issues

Background

The most critical guidance needed in order to support an orderly shift away from IBORs is to address whether a taxable event under Section 1001 occurs upon a contractual modification that switches a financial instrument from referencing an IBOR to an RFR. The timely amendment of existing financial instruments before 2021 is an essential component of a successful IBOR transition. However, concerns and uncertainty about whether such modifications may trigger taxable events will likely slow down this process and, as a consequence, lead to market disruption if the transition away from IBORs occurs in a rushed and disorderly manner.

Financial instruments of all types, including debt instruments, that provide for IBOR-based payments will need to be modified in light of the expected discontinuation of IBORs. These modifications will likely take place in two ways: (1) modification to fallback provisions, prior to the discontinuation of an IBOR, so that the rate will transition according to the fallback provision to an appropriate RFR, and (2) modification of the actual reference rate from an IBOR to an RFR. In the case of a financial instrument that has been modified based on approach (1), the actual operation of the fallback provision could be viewed as representing a second modification, albeit by the terms of the instrument.

In the case of a modification to a rate (situation (2)), modifications may in many cases be limited to a change in the referenced rate, including certain associated administrative changes,[9] with (i) appropriate 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 (ii) a one time, lump-sum payment in lieu of a spread adjustment. The spread adjustment may be calculated in various ways, including based on the difference between the levels of the IBOR and the replacement RFR at or around the time of the change in reference rate or a historical average of the differences between those rates.

The fallback provisions will operate similarly. The new ISDA standard fallback provision, which will be implemented through the ISDA protocol, is expected to provide for a detailed

[9] For certain instruments, administrative changes will be necessary to adjust computations and operational provisions to reflect the differences between the IBOR and the corresponding RFR. For example, because SOFR is an overnight rate, interest on financial instruments that pay periodically (*e.g.*, quarterly) is expected to be set in arrears by compounding or averaging the daily SOFR observations over the relevant period.

methodology for purposes of calculating this spread adjustment.[10] Many market participants are likely to adopt a similar methodology for the fallback provisions in modifications to their instruments based on bilateral agreements.

For uncleared over the counter derivatives contracts and debt instruments, as a legal matter the modification to the contract can generally be accomplished by a contractual amendment between the parties, although there may be operational or other practical impediments to doing so. For centrally cleared derivatives, other mechanisms for effecting a modification may be required, such as substituting what is in form a new contract for the original contract, but where the terms and fair market values of the substituted contract are equivalent to the original contract except for the rate (including a spread adjustment) and administrative changes necessary to effectuate the new rate. The ARRC continues to study the means by which market participants may seek to modify contracts (both over the counter and cleared) due to operational or other reasons, and will provide further information to Treasury and the IRS as it becomes available. The discussion below generally assumes that the parties make a legal amendment to an existing contract.

For U.S. federal income tax purposes, the modification of a financial instrument can potentially be treated as an exchange of the original instrument for a modified instrument, resulting in a taxable exchange under Section 1001. We refer generally to such an event as a "deemed reissuance." In the case of debt instruments, Treasury regulations provide that, in general, a significant modification results in an exchange, but a modification that is not significant does not.[11] A modification is defined as any alteration of a legal right or obligation of the issuer or holder of a debt instrument, other than (with exceptions not relevant here) one that occurs by operation of the terms of the instrument.[12] Therefore, the operation of fallback language upon the occurrence of its triggering event should not result in a taxable exchange of a debt instrument, assuming the fallback provision applies automatically.

A modification of a debt instrument is generally significant where, based on all of the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[13] The modification to a fallback provision likely falls under this general rule, and without a mechanical test it will in many circumstances be unclear whether such a modification is significant.

The regulations also provide specific rules for certain types of debt modifications, including an actual change in the yield of the instrument. Where the modification of a debt instrument results in a change in yield on the instrument of more than the greater of 25 basis points and 5 percent of the annual yield of the unmodified instrument, it is a significant modification.[14] For purposes of calculating the yield on a variable rate debt instrument ("VRDI"), which would include most debt instruments that reference an IBOR, the yield is defined as the yield of an equivalent fixed rate debt instrument based on the terms as of the date of the

[10] The ISDA protocol is expected to provide only for spread adjustments and not one-time payments.
[11] Treas. Reg. § 1.1001-3(b).
[12] Treas. Reg. § 1.1001-3(c).
[13] Treas. Reg. § 1.1001-3(e)(1).
[14] Treas. Reg. § 1.1001-3(e)(2).

modification.[15] Because the replacement of the IBOR with an RFR will likely be intended by the parties to result in a modified instrument of equal value to the unmodified instrument, it is possible that some modifications may be treated as not being significant under this rule. However, because market participants are expected to use spread adjustments that are based on historical averages of the difference between the IBOR and the relevant RFR, as opposed to a "snapshot" or "single observation" approach that compares the two rates only on the date of the modification, the modification may be deemed to be significant based on this rule. This could occur, for example, where there was volatility in the difference between the IBOR and corresponding RFR over the historical period used.

There is very limited guidance with respect to modifications of other financial instruments (*e.g.*, interest rate swaps and other derivatives), including for modifications occurring pursuant to the terms of the financial instrument. Moreover, unlike debt instruments, a change to the fallback language in an instrument and a subsequent change to the reference rate and spread pursuant to the terms of the fallback language might trigger taxable exchanges, even if the fallback provision operates automatically.

In addition to the potential to trigger gain or loss, a taxable exchange of a financial instrument could cause the instrument to be subject to any applicable tax rules that might be relevant to an instrument that is deemed to be newly issued "off market," including, in the case of a debt instrument, the OID rules or the bond premium rules. For a swap that is deemed to be newly entered into, its fair market value on that date would likely be treated as a deemed upfront payment.[16] Such a payment would be required to be amortized over the term of the swap[17] and might be required to be treated as a deemed loan if regulations regarding significant nonperiodic payments are issued under Section 1.446-3(g)(4).

A deemed entry into a new financial instrument could also have collateral effects under various provisions of the Code. For example, certain instruments are grandfathered under FATCA and/or Section 871(m) if they were issued before a certain date, but a taxable exchange would cause these instruments to be treated as new instruments and therefore no longer eligible for grandfathering. Similarly, any grandfathered bearer debt instruments would no longer be grandfathered for purposes of the various TEFRA provisions. Concerns about such consequences pose significant potential hurdles to modifying instruments potentially affected by them, as parties may decline to modify instruments in order to avoid them. An orderly transition away from IBORs therefore requires guidance that a taxable exchange will not occur.

For taxpayers that have integrated debt instruments and derivatives into synthetic debt instruments under Section 1.1275-6,[18] a deemed reissuance of the debt or the hedge could cause a "leg out," giving rise to a deemed disposition of the synthetic debt instrument for its fair

[15] Treas. Reg. § 1.1001-3(e)(2)(iv).
[16] For example, assume a taxpayer is party to a LIBOR-based swap that is deemed to be terminated in a taxable transaction when its fair market value is $50, in exchange for a new SOFR-based swap with a value of $50. The taxpayer would be presumably deemed to have paid $50 to acquire the new swap.
[17] Treas. Reg. § 1.446-3(f)(2).
[18] Integration allows a corporate taxpayer to avoid mismatches between the timing and character of income and deductions on the debt and the hedge, as well as to simplify the ongoing tax accounting and reporting of the attributes of the instruments.

market value and an inability to leg into a new synthetic debt instrument for 30 days. This effect could be very disruptive and burdensome for taxpayers with large hedged positions.

One-Time Payments. As discussed above, one-time payments may be made in addition to or in lieu of adjustments to the interest rate spread. Such one-time payments would, in general, represent the difference in present value between the pre- and post-modification expected payments and may be the preferred approach to a transition for a number of reasons. In some cases, one-time payments may represent the most practical (or, for certain operational reasons, the only viable) method to facilitate an amendment of a swap or other derivative to reference SOFR. This would generally be the case, for example, where two counterparties have entered into a large number of LIBOR-based derivatives with each other, those derivatives may have varying payment frequencies, maturity dates and other elements. The derivatives may include not only standard interest rate swaps, but other types of derivatives that reference LIBOR. In that context, should the parties wish to amend the portfolio of derivatives at once, it may be impractical to agree to a spread adjustment for the various LIBOR references in the portfolio as opposed to a simpler uniform substitution of SOFR coupled with a payment intended to compensate for any resulting difference in the aggregate portfolio value.

Besides considerations under Section 1001, another significant issue raised by these payments is how they would be taxed if paid to a recipient that is not a U.S. person, and in particular whether they would be subject to withholding tax as “fixed or determinable annual or periodical” income under Sections 1441 and 1442. The timing and character of these payments is also uncertain.

Tax-Exempt Obligations. The treatment of a change from an IBOR to an RFR for a tax-exempt debt instrument requires clarification. Subject to the discussion below, whatever guidance is provided for conventional debt instruments for the transition from an IBOR to an RFR should cover tax-exempt obligations as well.

Except as noted below, the tax law on the modification of conventional debt instruments is generally also applicable to tax-exempt debt instruments[19] as well as other tax advantaged debt instruments such as build America bonds.[20] Accordingly, the issues described above involving amending existing debt documents to provide a transition from an IBOR to an RFR are equally applicable to tax-exempt debt instruments.[21]

The consequences to a tax-exempt debt instrument of a deemed reissuance under Section 1001 can be severe. The deemed reissuance would be treated as a current refunding of the outstanding debt instrument, and the new debt instrument would have to be tested for continued qualification for tax exempt status. That would include applying current law for

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[19] Tax-exempt debt obligations are those the interest on which is excluded from gross income under Section 103.
[20] *See* Former Section 54AA.
[21] For tax-exempt debt instruments that are qualified tender bonds, modifications made in connection with a qualified tender are disregarded, but only if the changes are made pursuant to the terms of the original instrument. *See* the description in the preamble to recently proposed Treasury Regulations §1.150-3 (REG-141739-08; 83 F.R. 67701-67705). Accordingly, guidance is necessary for these instruments along with other tax-exempt debt obligations, notwithstanding their ostensibly greater flexibility.

qualification, which might be different from the law when the original debt instrument was issued. It would also necessitate updating expectations of qualified use of property, and new qualification opinions for qualified 501(c)(3) bonds (which can be a major undertaking for large 501(c)(3) borrowers, such as hospital systems and universities), both of which can impose a significant cost on issuers and borrowers. Some fact patterns could prove fatal to tax exemption following a deemed reissuance, such as private activity bonds trading at a discount if the issue price of the new debt instrument creates "imputed proceeds,"[22] or if there has been a recent change in ownership of certain bond financed property.[23]

For tax-exempt obligations, it is uncertain how one-time payments should be treated, and in particular (1) whether a payment from the issuer to holder constitutes interest for purposes of Section 103 and (2) whether a payment from the holder to the issuer is treated as additional proceeds of the bonds.

Request for Guidance

General Exception from Taxable Exchange

In order to facilitate the market transition from IBORs to RFRs, we request guidance providing that such a transition will not be a taxable event with respect to a debt obligation or other financial instrument. In order to make the process straightforward, such guidance should be broad and flexible. Specifically, and as discussed in more detail below, the scope of this guidance should include: (1) modifications to fallback provisions as well as to the referenced rate; (2) global IBORs in addition to USD LIBOR; (3) replacement rates that include SOFR and potentially any QFR and (4) modifications where the change in rate or fallback provision is compensated through either spread adjustments or a one-time payment.[24]

1. Modification methods

As described above, modifications are likely to be accomplished by amendments to the actual rate (benchmark rate plus spread) in an instrument as well as amendments to the fallback provisions. As a result, the guidance should be drafted broadly enough to encompass both situations. As noted above, the anticipated timing of the ISDA protocol means that guidance on fallback provisions is likely to be the most time-sensitive issue.

2. Rates being discontinued

While USD LIBOR is the rate most relevant to U.S. taxpayers, similar issues will arise for instruments that reference other IBORs. Accordingly, guidance is needed to address all of the IBORs because many may cease to be available at the end of 2021 (and, due to low transaction

[22] Treas. Reg. § 1.103-8(a)(6).
[23] Treas. Reg. § 1.150-1(d)(2)(v).
[24] As discussed in note 9 above, changes to an RFR will likely require other changes related to administrative aspects of interest calculation, such as setting the rate in arrears. If the general guidance under Section 1001 is broad, these changes should to some extent be subsumed in the change in rates, as these provisions are really elements of the rate itself. However, it would be helpful to get confirmation that ancillary changes of this nature do not give rise to a Section 1001 event.

volume, may cease to be reliable at a point prior to that date) requiring the modification of all instruments that reference such an IBOR. Facilitating U.S. taxpayers' modifications of instruments referencing such other IBORs, and to participate in ISDA protocols effectuating such modifications, will support the global market transition away from these IBORs to replacement RFRs.

3. Replacement rates

As described above, the ARRC has identified SOFR as the preferred alternative to USD LIBOR, and large segments of the market are expected to move to SOFR as the replacement rate for their USD LIBOR contracts. For other IBORs, in some cases replacement RFRs have been identified, while in other cases the replacement process is ongoing. The ARRC is aware of governmental bodies involved in such efforts, but in some cases non-governmental entities may play the leading role in selecting the replacement rate for other IBORs.

Accordingly, at a minimum the guidance should cover SOFR (in its various forms, such as term SOFR). It should also cover any rate adopted as the replacement rate for a certain IBOR by a government sponsored committee or that is sponsored or recommended by industry or other non-governmental organizations.

More generally, at least in the case of taxable instruments, Treasury and the IRS could apply the guidance to any replacement rate that is a QFR. This approach would provide flexibility to taxpayers and would address situations where there is not a single clear replacement rate for a particular IBOR. It would also provide clarity, since the QFR definition is familiar and widely used.

If the guidance permits the adoption of any QFR as a replacement rate, additional flexibility will be necessary for tax-exempt obligations. This is because a rate that is a multiple of a QFR will only be treated as a QFR itself if the multiple is greater than .65 but not more than 1.35.[25]

When a taxable index is used to set the interest rate for a tax-exempt debt instrument, the rate is usually specified as a percentage, *e.g.*, 70% of LIBOR, often adjusted with a spread. The percentage is sensitive to interest rate levels. In general, as interest rates rise or marginal tax rates are increased, that percentage declines and could go below 65%. In some market situations, tax-exempt rates can rise above taxable rates, as happened during the market crisis in 2008-2009, which could cause the percentage to rise above 100%.

If the guidance provided by Treasury on the transition from an IBOR index to an RFR index includes a requirement that the new index be a QFR, that should not require adherence to the limitation on multiples in Section 1.1275-5(b)(2)(i).[26] More generally, however the guidance defines an approved replacement rate, it should take into account that reference rates for tax-exempt obligations are likely to be multiples of rates used for taxable obligations.

[25] Treas. Reg. § 1.1275-5(b)(2)(i).
[26] For an example where similar relief was provided, *see* Treas. Reg. § 1.1275-4(d)(2)(ii)(D).

4. Compensating spread adjustments or one-time payments

RFRs are inherently less risky than IBORs, given that they are generally secured overnight rates, and therefore an IBOR will generally be significantly higher than its replacement RFR at any given time. As a result, in order to maintain the general value of a debt obligation or other financial instrument, an adjustment will need to be made to reflect the difference between the two rates. Contractual fallback provisions may handle this issue by taking into account the current difference between the two rates at the time the fallback is triggered, or, more likely, an average of the difference between two rates over a prior period. Based on that difference, the RFR-based rate in the modified instrument will generally have a higher "spread" than that of the IBOR it replaces. Apart from fallback provisions, market participants engaging in bilateral modifications to change the actual rates in a contract are likely to employ similar spread differentials in order to maintain economic equivalence between the original and modified instrument. Accordingly, any guidance should be flexible enough to allow adjustments to the spread based on a variety of metrics aimed at economic equivalence, such as the average difference between the IBOR and RFR over a period, and should not require that parties equalize the rates based on the rate differential or spread as of date of the modification.

In lieu of spread adjustments, parties bilaterally modifying an instrument, or a group of instruments, may make one-time compensatory payments. Consistent with the treatment of modifications to replace reference rates and adjust rate spreads discussed above, one-time payments should be permitted without triggering a taxable exchange under Section 1001, provided that they are equal to the amount determined by the parties to reflect the difference in fair market value between the original and modified instrument or instruments. This will allow market participants flexibility to modify contracts in the simplest and most practical manner that applies to the particular circumstances.

Because so many categories of transactions reference IBORs, and these contracts are likely to be amended in varying ways, it is important that guidance be flexible as to the replacement compensation or methodology. Nonetheless, we appreciate that Treasury and the IRS may have concerns that the parties may make unrelated modifications concurrently with an IBOR replacement, and therefore may want to clarify that any such other modifications are subject to general Section 1001 principles. In the case of modifications to the spread above the replacement rate or one-time payments, we believe that the guidance could address this issue by covering only such items to the extent that they are intended to preserve the fair market value to the parties after accounting for changes in the reference rate. The guidance could clarify that, in making this determination, parties may use any reasonable valuation methodologies to reflect the differences in the rates, which may include averaging periods. The guidance could also provide a safe harbor under which a taxpayer's replacement methodology will be deemed to be reasonable if it is consistent with methodologies recommended by major industry organizations such as ISDA. Any unrelated concurrent changes to the instrument would continue to be analyzed under general tax principles.

Additional Issues for One-Time Payments

To enable market participants to make one-time payments in lieu of spread adjustments, guidance addressing important issues relating to such payments should be provided. In particular, if market participants have the concern that one-time payments to non-

U.S. counterparties are subject to withholding rules that differ from those applicable to other payments on the relevant instrument, that concern will be a major deterrent to such payments. Accordingly, we request guidance that, for purposes of Sections 1441 and 1442, the source and character of such payments (*e.g.*, as interest) will be the same as a payment with respect to the instrument.

While not as crucial, guidance regarding the timing and character of these payments to U.S. taxpayers would also be helpful. In the absence of guidance, we would expect market participants to take differing positions as to such treatment. In the event that no guidance is provided, the ARRC believes that such positions should be respected if reasonable and internally consistent.

The guidance addressing one-time payments should cover tax-exempt debt instruments as well. It should specify whether a one-time payment by an issuer to a holder constitutes interest for purposes of Section 103. Any one-time payment by a holder to an issuer should be treated as an adjustment to interest on the debt instrument and not as additional proceeds of the bonds.

III. <u>Additional Issues relating to the IBOR Transition</u>

A. REMICs

Background

The switch from an IBOR to an RFR also raises issues regarding the qualification of REMICs with respect to both qualified mortgages and regular interests. REMICs may have both regular interests with a variable rate based on an IBOR and hold mortgages with variable interest rates, so the transition to the RFRs may affect them in multiple ways. In particular, modifications of regular interests will require legal opinions confirming that the REMIC will continue to qualify as such, so the lack of certainty on this issue will potentially cause delays and/or failures to make the modifications needed for a smooth transition. These issues are also compounded by the fact that many REMICs hold regular interests in other REMICs, and if one REMIC fails to qualify it could have a domino effect on the qualification of the REMIC(s) that hold interests in it.

There are several requirements in order for an entity to qualify as a REMIC, including that substantially all of the assets of the entity consist of qualified mortgages and permitted investments and that the regular interests in the REMIC were issued on the startup day with fixed terms.[27] Both the qualified mortgages and the regular interests often have interest rates determined by reference to an IBOR. Treasury regulations specifically provide that there will not be a deemed disposition of qualified mortgages for purposes of the REMIC rules if the qualified mortgage is not treated as exchanged for purposes of Section 1001.[28] Therefore, the general guidance we are requesting with respect to Section 1001 regarding a change to an RFR will, if

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[27] Sections 860D(a); 860G(a)(1).
[28] Treas. Reg. § 1.860G-2(b).

sufficiently broad, address the qualification issue with respect to qualified mortgages.[29] However, there is no reference to the Section 1001 rules for purposes of determining that the terms of the regular interests were fixed as of the startup day.[30] While it seems reasonable to apply the same principle and conclude that the terms would be treated as fixed absent an exchange under Section 1001, the lack of a reference to Section 1001 could be interpreted as implying that it does not apply.

In addition, regular interests are only permitted to have certain specified contingencies, including remote contingencies.[31] Fallback language in REMICs issued after the point where the likelihood of the IBOR ceasing to be published was no longer remote could potentially fail this requirement even though the contingency is merely to switch to an economically equivalent interest rate in order to address the fact that the IBOR is no longer published.[32]

Request for Guidance

The guidance requested above under Section 1001, if sufficiently broad, would address the issues regarding qualified mortgages, but further guidance is needed to clarify that REMICs will not fail to qualify due to the requirements that regular interests be issued with fixed terms and no contingencies.

It would be helpful to receive separate guidance confirming that where a regular interest in a REMIC is not subject to a taxable exchange under Section 1001, modifications to the reference rate, spread and related administrative provisions will not cause the regular interest to be treated as not having fixed terms on the REMIC's startup day.

In addition, it would be helpful to receive guidance that regular interests that refer to an IBOR and contain a fallback provision providing for an RFR will not fail to have a qualified variable rate merely because it is not remote that the interest will be calculated based on the RFR and adjusted spread once the IBOR is no longer published (or upon an earlier event related to the unreliability of the IBOR). Without this guidance, there is uncertainty whether any newly formed REMIC can issue a regular interest that refers to an IBOR because the reality that the IBORs will cease to be published must be addressed in the instrument.

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[29] Parties may "strip" REMIC fixed-rate regular interests, using a grantor trust, to create (1) a floating-rate bond and (2) an inverse floating rate interest-only instrument. *See* Section 1286; *see also* I.R.S. Priv. Ltr. Rul. 201229003 (Apr. 19, 2012); I.R.S. Priv. Ltr. Rul. 200624005 (Mar. 6, 2006). We expect the general guidance we are requesting with respect to Section 1001 will address any deemed exchange concerns that may be presented by a modification of these instruments from referencing an IBOR to an RFR (or a modification of their fallback provisions).

[30] *See* Treas. Reg. § 1.860G-1(a)(4).

[31] Treas. Reg. §§ 1.860G-1(a)(5), 1.860G-1(b)(3).

[32] Additionally, there may be other costs that are incurred in adopting any change to a REMIC (for example, relating to revising deal documents or delivering opinions). Where the REMIC investors bear such costs, funds may be diverted from principal or interest that is owed to regular interest holders. The ARRC believes that the potential for the payment of such costs does not entail a "contingency" for purposes of Treas. Reg. § 1.860G-1(a)(5). It would be helpful for Treasury and the IRS to provide guidance confirming this treatment.

B. Original Issue Discount Issues

Background

As discussed above, floating-rate debt instruments typically provide for "fallback" provisions that establish the debt instrument's interest rate in circumstances in which the initial methodology for setting the interest rate can no longer be used. As the risk that LIBOR and other IBORs will be discontinued has increased, the market has moved toward documentation for IBOR-based debt instruments that includes fallback provisions that are intended to facilitate a future switch to an established market replacement rate such as SOFR. Because the market has not yet coalesced around a methodology for replacing LIBOR (and other IBORs), these provisions are often drafted to allow a calculation agent some discretion to follow a market standard replacement methodology, as opposed to a contractually hardwired formula.

Debt instruments that pay interest at variable rates and that meet certain requirements are treated as VRDIs.[33] VRDI treatment generally applies to, *inter alia*, a debt instrument that provides for one or more QFRs.[34]

In the case of debt instruments providing for interest at a single QFR, no stated interest is considered to be OID.[35] If a debt instrument instead provides for interest at two or more QFRs, OID is calculated using a fixed rate substitute for each QFR as of the issue date (equal to the value of such QFR on such date).[36] If one fixed rate substitute exceeds the other on the issue date, the excess will be treated as OID, unless it is *de minimis*. While in some circumstances two or more QFRs may be treated as a single QFR, this rule is limited.[37]

Floating-rate debt instruments that are not VRDIs are generally treated as contingent payment debt instruments ("CPDIs"). CPDIs are generally subject to the "noncontingent bond method" in Section 1.1275-4(b), which results in the holder and issuer recognizing interest income or deductions at times other than when cash payments are made. An exception to CPDI treatment applies to contingencies that are remote or incidental.[38] Under the rules for remote and incidental contingencies, if a remote contingency actually occurs, contrary to assumptions, or a payment subject to an incidental contingency becomes fixed in an amount that is not insignificant (such events described in (i) and (ii), "changes in circumstances"), the debt instrument is treated, solely for the purposes of calculating OID, as retired and reissued for an amount equal to the debt instrument's adjusted issue price.[39] It is not entirely clear how the remote and incidental contingency rule interacts with the VRDI rules, *e.g.*, whether a remote or incidental contingency in an interest rate formula affects whether the rate is a QFR and whether

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[33] *See generally* Treas. Reg. § 1.1275-5.
[34] Treas. Reg. § 1.1275-5(a)(3)(i).
[35] *See generally* Treas. Reg. § 1.1273-1.
[36] Treas. Reg. § 1.1275-5(e)(3).
[37] *See* Treas. Reg. § 1.1275-5(b)(1) (treating two QFRs as a single QFR if they can reasonably be expected to have approximately the same values throughout the term of the instrument, and providing for a conclusive presumption that this is the case where the values of the rates are, on the issue date, within 25 basis points of each other).
[38] Treas. Reg. § 1.1275-2(h)(1).
[39] Treas. Reg. § 1.1275-2(h)(6).

a deemed reissuance for OID purposes could arise upon a change in circumstances that affects the rate.

The higher likelihood that a fallback provision will become operative presents basic questions under the OID rules. If the replacement rate is considered to be a QFR that is separate from the initial IBOR reference rate, it would be unclear how to calculate OID since in most cases the date of the substitution, the specific replacement rate and the spread above the applicable replacement rate (and therefore the "fixed rate substitute") are not known as of the issue date. Furthermore, certain fallback rates, such as SOFR, may not have existed at the time of issuance.[40] Conceivably, these uncertainties could give rise to an argument that the debt instrument is a CPDI instead of a VRDI.

However, we think it more appropriate to view the replacement rate contemplated by such a fallback provision not as a separate QFR, but rather a component of a single overall rate methodology. Most debt instruments providing for a floating rate contain some kind of alternate method for calculating the rate if the initial calculation method is impaired in some way, and these provisions have historically not been viewed as separate rates.

Request for Guidance

Treasury and the IRS should provide guidance clarifying that a debt instrument (including a tax-exempt debt instrument) that references an IBOR and a methodology designed to produce a fallback rate, such as SOFR or another QFR,[41] that replaces the IBOR in circumstances in which the IBOR is no longer available or reliable is treated as referring to a single QFR for purposes of the Treasury regulations governing OID on VRDIs. As a policy matter, this approach is especially appropriate where, as would be in the case in an IBOR transition, parties to a debt instrument would be focused on preserving the value of a debt instrument by means of the fallback provision.

Furthermore, Treasury and the IRS should confirm that the transition from an IBOR to an RFR pursuant to this type of fallback provision should not result in a change in circumstance necessitating a deemed satisfaction and reissuance for OID purposes.

There would seem to be little benefit to the government in requiring taxpayers to recognize OID on these instruments, because there is no way of knowing in advance whether such a requirement will increase or decrease taxable income, or whether it will result in a clearer reflection of income. What is certain is that requiring the calculation of OID, whether under the VRDI rules or the CPDI rules, would increase complexity and the cost of tax administration for taxpayers.

C. Interest Expense Calculation Under Treasury Regulation Section 1.882-5

[40] The publication of overnight SOFR began in April 2018.

[41] We understand that term SOFR has been calculated in varying ways, including by compounding daily SOFR between coupon payment dates as well as averaging daily SOFR between coupon payment dates. We believe that the definition of QFR as a rate that "can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds" is flexible enough to apply to both of these methodologies.

Background

Under Section 1.882-5, the amount of interest expense that a foreign corporation may deduct against its effectively connected income is determined in a three-step process. First, the foreign corporation must determine its average effectively connected assets. Second, the foreign corporation must determine the liabilities connected to those assets and, finally, the foreign corporation must determine the associated interest expense by use of either the Adjusted U.S. Booked Liabilities method ("AUSBL") or Separate Currency Pools method ("SCP").

Under the AUSBL method, when a foreign corporation's effectively connected liabilities exceed its U.S. booked liabilities, the foreign corporation must determine the interest expense to apply to these excess liabilities. The simplest option, as prescribed in Section 1.882-5(d)(5)(ii)(B), allows the taxpayer to elect to compute its excess interest by applying published average 30-day LIBOR for the year to the excess liabilities. A far more administratively cumbersome option, prescribed in Section 1.882-5(d)(5)(ii)(A), requires the taxpayer to gather data on its USD liabilities booked outside the United States and related interest expense in order to compute an interest rate to apply to the excess liabilities.

Absent guidance from Treasury or the IRS, or an amendment to the regulations that would replace LIBOR with an RFR, taxpayers will presumably be forced to use the more cumbersome method once LIBOR is no longer available.

Request for Guidance

Treasury and the IRS should provide guidance that permits taxpayers to use an appropriate RFR in place of LIBOR in Section 1.882-5(d)(5)(ii)(B).

D. Potential Change In Method Of Accounting

Background

Under Section 475, securities, including loans, are generally subject to mark-to-market tax treatment if held by a taxpayer that is a "dealer in securities." In many cases securities dealers value loans and other debt instruments for which market prices are not readily available using a discounted cash flow model. Such a model may employ an IBOR or other appropriate discount rate to reflect market interest rates. A discounted cash flow model may also be used for the valuation of certain swaps and other derivatives.

A dealer that has historically used an IBOR to value categories of securities using a discount cash flow model for purposes of Section 475 will need to apply a different discount rate at the time that the IBOR is no longer published or is no longer viewed as an appropriate discount rate (*e.g.*, due to reliability concerns).

Section 446(a) sets forth the general rule that taxable income "shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Once a method of accounting has been adopted, a taxpayer must obtain

consent from the IRS to change it, even in the case of a change from an improper method to a proper method.[42]

Applicable Treasury regulations provide that "[a] change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also, a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting."[43] The term "item" is used to indicate any recurring incidence of income or expense.[44] An item is "material" if it involves the proper time for the inclusion of the item in income or the taking of a deduction.[45] However, a change in treatment resulting from a change in underlying facts is not a change in method of accounting.[46]

It is unclear as a matter of law whether a change in discount rates would constitute a "change in treatment of a material item" for the purposes of Section 446 and whether, if so, such change would occur as a result of a "change in underlying facts." In particular, if a dealer seeks to use SOFR prior to the time at which LIBOR becomes unavailable, it will be less clear that a change in underlying facts has occurred.

Request for Guidance

Treasury and the IRS should provide guidance confirming that the change of a discount rate used for purposes of Section 475 valuations of securities from an IBOR to another rate, either in anticipation of the discontinuation of such IBOR or at the time at which the IBOR no longer is available, does not constitute a change of accounting method.

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[42] Furthermore, Section 481(a) generally requires, in calculating a taxpayer's income for any year in which a change of method of accounting has occurred, that certain adjustments "necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted" be taken into account, except that such adjustments are not to be made to any taxable year in which a change of accounting method was not made "unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer."

[43] Treas. Reg. § 1.446-1(e)(2)(ii)(a). For dealers in securities, securities often constitute "inventory."

[44] Examples of "items," as provided by examples in applicable Treasury regulations and in cases and rulings, include real estate taxes, annual fees for certain licenses and corporate officers' bonuses. If similar items differ in some way that affects the way they are accounted for, it is likely they are separate "items."

[45] Treas. Reg. § 1.446-1(e)(2)(ii)(a).

[46] Treas. Reg. § 1.446-1(e)(2)(ii)(b).