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Report No. 1430
December 27, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1430 – Report on IBOR Transition Proposed Regulations*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1430 commenting on proposed regulations issued by the Internal Revenue Service and the Department of the Treasury addressing the phase-out of "interbank offered rates" such as USD LIBOR and the attendant amendments to the terms of debt instruments and non-debt contracts in light of the phase-out. We welcome the proposed regulations and commend the Internal Revenue Service and the Department of the Treasury for the helpful guidance.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

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Report No. 1430

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON IBOR TRANSITION PROPOSED REGULATIONS

December 27, 2019

This Report[1] comments on proposed regulations (the "***Proposed Regulations***")[2] issued by the Internal Revenue Service (the "***IRS***") and the Department of the Treasury (collectively with the IRS, the "***Treasury***") addressing the phase-out of "interbank offered rates" ("***IBORs***") such as USD LIBOR and the attendant amendments to the terms of debt instruments and non-debt contracts in light of the phase-out.

Part I summarizes our recommendations and comments, Part II provides background of the IBOR transition and the Proposed Regulations, and Part III discusses our recommendations and comments.

I. Summary of Principal Recommendations and Comments

1. In the case of unrelated parties, the Substantial-Equivalence-of-FMV rule (as defined below)[3] should apply only in cases involving both Qualifying IBOR Alterations (as defined below) and OCAs (as defined below).

2. The Substantial-Equivalence-of-FMV rule should be de-linked from the definition of "qualified rate" and instead presented as an additional requirement for qualification under the general rule.

3. Consideration should be given to aligning the consequence of failing to meet the Substantial-Equivalence-of-FMV rule more closely with the purpose of the IBOR-transition rule.

4. If the "arm's length negotiation" safe harbor is retained, it should be clarified.

5. Consideration should be given to simplifying the definition of "qualified rate."

6. Final regulations should limit the qualification of one-time payments as AAs (as defined below). Specifically, one-time payments from the issuer to the holders should be considered AAs only where the fixed spread component of the QR is no smaller than that of the IBOR-referencing rate. In cases involving a disqualification under this limitation, consideration should be given to whether such disqualification prevents all the alterations from being Qualifying IBOR Alterations.

7. Final regulations should provide that one-time payments treated as AAs should be taken into account over the remaining life of the debt instrument as original issue discount.

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[1] The principal author of this report is Jeffrey Maddrey. Substantial contributions were made by Tyler Arbogast. Helpful comments were received from Bora Bozkurt, Peter Connors, Lucy Farr, Robert Kantowitz, Stephen Land, Deborah Paul, Michael Schler, Michael Shulman, and Michael Yaghmour. This report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-118784-18, Federal Register Vol. 84, No. 196, October 9, 2019, at 54068-54079.

[3] Prop. Reg. § 1.1001-6(b)(2).

8. Consideration should be given to whether more specific guidance in respect of source and character of a one-time payment associated modification in relation to a non-debt contract should be provided.

9. The timing of inclusions and deductions of one-time payments in relation to a non-debt contract should be addressed. Final Regulations should provide that a one-time payment associated modification with respect to an NPC (as defined below) is treated as a non-periodic payment and therefore taken into account over the remaining life of the NPC rather than when paid or received. Consideration could be given to a general catch-all timing rule in Prop. Reg. § 1.1001-6(d) for a one-time payment associated with modifications of non-NPC non-debt contracts.

10. Under final regulations, an integrated transaction should not be considered to be legged out merely because a component debt instrument or component hedge (or both) on a standalone basis is changed in a manner covered by Prop. Reg. § 1.1001-6.

II. Background and Summary of the Proposed Regulations

A. Transition from IBORs to ARRs

A large volume of outstanding debt provides for interest determined by reference to an IBOR such as USD London Interbank Offer Rate ("***LIBOR***"). An even larger volume of derivatives reference IBORs. For years, IBORs have been the most widely used reference interest rates.

Market participants and regulators have, however, been seeking to develop new reference interest rates (referred to as "alternative reference rates") that would take the place of IBORs (including USD LIBOR) in future transactions. In the United States, the Alternative Reference Rates Committee ("***ARRC***") convened by the Federal Reserve Board and the Federal Reserve Bank of New York has coordinated these efforts.[4] The collective goal has been to identify alternative reference rates that are both more robust than USD LIBOR and that would be based on accepted principles for financial benchmarks. In 2018, the ARRC published a report recommending that market participants adopt the newly-defined broad Treasury repo financing rate -- the Secured Overnight Funding Rate ("***SOFR***") – as the replacement for USD LIBOR.[5]

A significant motivation for developing new alternative reference rates is the likely elimination of LIBOR as early as 2022. LIBOR rates are determined from rates voluntarily provided by 20 banks. The rates supplied are used to produce specific LIBOR rates in five currencies across seven specific tenors. For any given currency and tenor, the individual rates supplied by the panel banks are supposed to reflect the rate at which banks could borrow on unsecured terms in wholesale markets. Thus, the LIBOR rates are supposed to reflect current-market consensus wholesale borrowing rates in specific currencies at specific tenors. But, the

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[4] Information about the ARRC including its membership, *ex officio* membership, and non-member observers can be found at https://www.newyorkfed.org/arrc.

[5] Second Report of the Alternatives Reference Rate Committee (March 2018), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.

reliability and sustainability of LIBOR benchmark rates have been questioned. To facilitate a transition away from LIBOR, the U.K. Financial Conduct Authority has obtained the agreement of the panel banks to continue to submit to LIBOR until the end of 2021. The U.K. Financial Conduct Authority has warned that market participants must remove dependencies on LIBOR by the end of 2021 in order to avoid disruption.[6]

As a practical matter, parties to existing contracts that reference LIBOR and other IBORs will need to (i) terminate their IBOR-dependent contracts, (ii) amend the contracts to replace the contract's reference to IBOR with a reference to an ARR such as SOFR, or (iii) amend the contracts so that they continue to reference an IBOR but provide for a "fallback" ARR in the even the IBOR becomes unavailable or unreliable.

B. Primary Tax Issues

The ARRC expressed concern that, absent guidance regarding tax consequences, parties to IBOR-dependent contracts may resist removing IBOR-dependent terms.

In the case of debt instruments, the primary concern is whether the alterations necessary to remove and replace an IBOR-referencing rate would accelerate taxable income (or loss) into the period of the alteration. If the alterations were to trigger a debt-for-debt exchange under Treas. Reg. § 1.1001-3, a holder would realize gain (or loss) upon the exchange equal to the difference between the issue price of the "new" debt received in the exchange and the holder's basis in the "old" debt. Unless a nonrecognition rule applies, the realized gain (or loss) is taken into account currently. From the issuer's perspective, a debt-for-debt exchange generally results in a current item of either cancellation-of-indebtedness ("***COD***") income or bond repurchase premium expense. In addition, a debt-for-debt exchange generally triggers the recognition of unamortized debt issuance costs associated with the old, retired debt. These consequences can be viewed as "accelerations" because, absent the exchange, these amounts would be taken into account in later periods.

Another concern in the case of debt instruments is the tax treatment of a one-time payment made in conjunction with IBOR-transition alterations where the alterations do not trigger a debt-for-debt exchange.[7] Both the ARRC comments and the Proposed Regulations envision that in conjunction with the removal and replacement of an IBOR-referencing rate, the parties could negotiate for a one-time payment instead of an adjustment to the fixed-rate component of the floating rate. Absent guidance, the treatment of one-time payments could be uncertain or burdensome.

Returning to debt-for-debt exchanges, the concerns extend beyond acceleration. For example, to the extent a particular tax rule depends on the issue date of the debt, a debt-for-debt exchange may reset the issue date.

6 *See* https://www.fca.org.uk/markets/libor.

7 Such one-time payments differ from a customary "consent payment" paid by an issuer of widely held debt to induce holders to permit amendments to a debt instrument. One-time payments under the Proposed Regulations are payments that are made in lieu of the fixed-spread component of the variable rate.

In the case of non-debt contracts, modifications to remove IBOR-dependent terms raise the same tax issues: Does the modification result in an "exchange" triggering gain (or loss) realization? In the absence of a deemed exchange, how do the parties tax account for a one-time payment? Finally, are there collateral consequences that need be considered?

C. The Proposed Regulations

1. Debt

a. Qualifying IBOR Alterations are excluded from Treas. Reg. § 1.1001-3

The general rule of Prop. Reg. § 1.1001-6(a)(1) excludes from Treas. Reg. § 1.1001-3 significant modification testing certain alterations to the terms of debt that have the effect of replacing an IBOR-referencing rate with another floating rate. This exclusion applies only to alterations reasonably necessary for the narrow purpose of facilitating the transition from IBOR-referencing rates. We will refer to the alterations within the scope of this rule (and therefore excluded from Treas. Reg. § 1.1001-3) as "***Qualifying IBOR Alterations***." Qualifying IBOR Alterations consist of: (i) alterations that replace an IBOR-referencing rate with a "qualified rate" ("***QR***") and (ii) "associated alterations" ("***AAs***").[8]

A QR is a floating rate of interest that would be a "qualified floating rate" ("***QFR***") under the variable rate debt instrument ("***VRDI***") rules provided that the "Substantial-Equivalence-of-FMV" test (discussed below) is met.[9] Under the VRDI rules, a QFR is a variable rate such that variations in 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.[10] (The Proposed Regulations enumerate 11 specific types of QRs, the tenth item on the list being a QFR under the VRDI rules. Each of the other enumerated rates is also a QFR under the VRDI rules and therefore the other 10 items are better viewed as illustrations rather than stand-alone rules.) A QFR, and therefore a QR, does not need to be entirely variable. A variable rate plus a fixed number of basis points (a "spread") is also a QFR and therefore a QR.[11]

The Proposed Regulations contemplate two types of AAs.[12] The first type consists of alterations of a technical, administrative, or operational nature that are reasonably necessary to implement the replacement of the IBOR-referencing rate with a QFR. Examples include changes to the interval of time over which the interest rate is reset (e.g., monthly to daily), changes to the dates on which interest is paid, and changes to compounding and changes to day-count conventions. The second type of AA is a "one-time payment" necessary to ensure that the

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8 Prop. Reg. § 1.1001-6(a)(1).

9 Prop. Reg. § 1.1001-6(b). The definition of QR in Prop. Reg. § 1.1001-6(b) does not, however, contain the restriction on interest-rate multiples that the VRDI definition of QFR contains. Under Treas. Reg. § 1.1275-5(b)(2), a QFR also includes a rate equal to the product of a QFR and a multiplier that is greater than .65 and less than 1.35. The Proposed Regulations specifically cross-reference the VRDI definition of QFR without the multiplier restriction.

10 Treas. Reg. § 1.1275-5(b).

11 Treas. Reg. § 1.1275-5(b)(2)(ii) (QFR includes a QFR "increased or decreased by a fixed rate").

12 Prop. Reg. § 1.1001-6(a)(5).

replacement of an IBOR-referencing rate with a QFR does not shift value from the issuer to the holder or vice versa.

> **Example 1.** One-time payment. Issuer has outstanding debt that provides for semiannual payments of interest, was issued without original issue discount ("***OID***") and is not puttable. The interest rate is 6-month USD LIBOR plus 100 basis points. Issuer offers to exchange the debt for new debt having all of the same terms (principal amount, payment dates, maturity date, seniority, etc.) except that the interest rate will now be equal to SOFR plus 100 basis points. The parties reasonably believe that, given expected differences between the amount of interest expected to be paid under the SOFR and 6-month USD LIBOR, the aggregate amount of interest to be paid under the SOFR debt would be materially less than the aggregate amount to be paid under the LIBOR debt. As a result, the parties reasonably believe the fair market value ("***FMV***") of the SOFR debt will be only 90% of the FMV of the LIBOR debt. To ensure the amendment does not transfer value from holders to the issuer, the issuer agrees to make a one-time payment to holders equal to this difference. This one-time payment is an AA.

b. Substantial-Equivalence-of-FMV rule

The Proposed Regulations provide that notwithstanding the general definition of QR, an otherwise qualifying QR will not be considered a QR if the alterations necessary to remove and replace the IBOR-referencing rate, standing alone, change the FMV of the debt (the "***Substantial-Equivalence-of-FMV***" rule).[13] If the FMV of the debt immediately before the change is not substantially equivalent to the FMV of the debt immediately after (adjusted for any one-time payment necessary to equalize FMV), none of the alterations will be Qualifying IBOR Alterations and Prop. Reg. § 1.1001-6 will not apply. Lacking the protection of Prop. Reg. § 1.1001-6, the alterations would be tested under Treas. Reg. 1.1001-3 just as any other alteration would be.

Under the Proposed Regulations, the parties "may use any reasonable, consistently applied valuation method" to determine FMV. In addition, the regulations provide two safe harbors – one based on historic average rates and the other based on arm's length negotiation.[14] The historic average rate safe harbor is a mechanical look-back rule. The test is satisfied if there is less than a 25-basis point difference in the historic average relevant IBOR-referencing rate and the historic average of the replacement rate taking into account any one-time payment AA. The arm's length negotiation standard is met if the parties are unrelated and they determine, based on bona fide arm's length negotiations between them, that the FMV of the debt instrument before the alterations to be tested under Prop. Reg. § 1.1001-6(a)(1) is substantially equivalent to the FMV of the debt instrument after the alteration.

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[13] Prop. Reg. § 1.1001-6(b)(2).

[14] Prop. Reg. § 1.1001-6(b)(2)(ii).

c. <u>Other Contemporaneous Alterations</u>

Alterations that are not Qualifying IBOR Alterations are required to be tested under Treas. Reg. § 1.1001-3, as always. These alterations are referred to as "other contemporaneous alterations" ("***OCAs***") and consist of any changes to the terms of a debt instrument *<u>other than</u>* (i) the removal of an IBOR-referencing rate, (ii) the addition of a QR, and (iii) an alteration that is "reasonably necessary" to effectuate the rate substitution (i.e., an AA).[15]

Where both Qualifying IBOR Alterations and OCAs exist, the Proposed Regulations envision a two-step process under which the Qualifying IBOR Alterations are deemed to occur immediately before the OCAs.[16] In this case, the Substantial-Equivalence-of-FMV rule is applied by comparing the FMV of the debt before the transaction to the FMV of a hypothetical debt instrument that has undergone the Qualifying IBOR Alterations but not yet undergone the OCAs.

d. <u>Fallback Provisions</u>

A fallback provision of a debt instrument is a provision addressing the possibility of an IBOR being eliminated. Some debt instruments do not provide for a fallback provision currently, while others provide for fallbacks but the fallback needs to be adjusted to reflect current best practices. The Proposed Regulations provide that an alteration to the terms of a debt instrument to include a QR as a fallback rate, including associated alterations, are excluded from Treas. Reg. § 1.1001-3.

2. <u>Non-debt contracts</u>

The Proposed Regulations provide rules for non-debt contracts that mirror the rules for debt instruments described above. In general, for non-debt contracts, a change to a QR and any "associated modification" (the non-debt analog to an "associated alteration") does not result in a realization event under Treas. Reg. § 1.1001-1(a).

3. <u>Tax-accounting for one-time payments</u>

The Proposed Regulations provide that the "source and character" of a one-time payment is the same as the source and character that would otherwise apply to a payment by the payor.[17] The "source and character" rule is silent as to timing.

4. <u>Integrated transactions</u>

The Proposed Regulations provide that an alteration to the terms of a debt instrument or modification of the terms of a derivative to replace an IBOR-referencing rate with a QR on one

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[15] Prop. Reg. § 1.1001-6(a)(4).

[16] Prop. Reg. § 1.1001-6(a)(4).

[17] Prop. Reg. § 1.1001-6(d).

or more legs of the transaction is not treated as a legging-out of the integrated transaction provided that the combined cash flows remain eligible for integrated treatment.[18]

5. Additional rules

The Proposed Regulations also provide that Qualifying IBOR Alterations do not cause an instrument to fail to qualify as a regular interest in a REMIC or to lose its grandfathered status under section 1471.[19] In addition, the Proposed Regulations contain special rules for determining the amount and accrual of OID in the case of VRDI containing a fallback provision and modify a rule under which foreign banks can calculate interest expense attributed to excess U.S.-connected liabilities.[20]

III. Discussion

A. Overall Approach

The Proposed Regulations seek to avoid any immediate tax impact from changes to the terms of a debt instrument or non-debt contract where the economic objective is simply to replace an IBOR-referencing rate with an alternative rate that, like the IBOR-referencing rate it is replacing, measures the cost of newly borrowed funds. In this narrow case, the replacement of one floating rate with another has the feel of a small adjustment to the original economic deal, not the beginning of a new one and, as a policy matter ought not rise to the level of an exchange. In the absence of the Proposed Regulations, a no-exchange-for-tax result is far from certain. The mechanical nature of "significance" testing under Treas. Reg. § 1.1001-3 could compel a debt-for-debt exchange conclusion despite the common-sense view that not much has changed. For non-debt contracts, the "materially different in kind or extent" standard of Treas. Reg. § 1.1001-1(a) allows for a no-realization event conclusion but given the limited available guidance and inherently factual nature of the inquiry, such a view could always be challenged. The certainty the Proposed Regulations provide is appreciated and welcome.

B. Debt Instruments

1. Exclusion of Qualifying IBOR Alterations from Treas. Reg. § 1.1001-3

Absent the Proposed Regulations, IBOR-transitioning alterations would clearly constitute "modifications" that would need to be tested for "significance" under the specific tests of Treas. Reg. § 1.1001-3(e). The change-in-yield test of Treas. Reg. § 1.1001-3(e)(2) compares the fixed yield of the original debt to the fixed yield of a hypothetical debt instrument deemed issued on the date of the modification for an issue price equal to the adjusted issue price of the debt as of that date (adjusted for any one-time payment made as of that date) and providing for cash flows consistent with the post-alteration terms. Where the debt provides for a variable rate of interest, the comparison is of two "equivalent fixed-rate debt instruments" whose fixed yields

[18] Prop. Reg. § 1.1001-6(c).

[19] Prop. Reg. §§ 1.860G-1(e), 1.1001-6(e).

[20] Prop. Reg. §§ 1.1.1275-2(m), 1.882-5(a)(7)(i), (d)(5)(ii)(B).

can be compared.[21] The equivalent fixed-rate debt instrument process adds complexity and departs from the actual economics of the transaction. The practical effect is that small differences in the current levels of the variable rates (differences that might in fact be temporary) are deemed permanent and magnified and solidified in the construction of the equivalent fixed-rate debt instruments potentially resulting in a "significance" conclusion for a change that may not be economically meaningful.

The Proposed Regulations directly address this concern by excluding Qualifying IBOR Alterations from Treas. Reg. § 1.1001-3 altogether. We welcome the approach of the Proposed Regulations that side steps testing under Treas. Reg. § 1.1001-3(e).

2. Substantial-Equivalence-of-FMV rule

The Substantial-Equivalence-of-FMV rule limits the scope of Prop. Reg. § 1.1001-6 to Qualifying IBOR Alterations that, in the aggregate do not shift value from the issuer to the holders (or vice versa). Specifically, the FMV of the debt immediately before the Qualifying IBOR Alterations must equal the FMV of the debt immediately after, taking into account any one-time payment. If the Substantial-Equivalence-of-FMV standard is not met, Prop. Reg. § 1.1001-6(a)(1) is inapplicable and the IBOR-transition alterations must be tested under Treas. Reg. § 1.1001-3.

The Substantial-Equivalence-of-FMV test appears necessary only when a transaction includes OCAs that must be tested under Treas. Reg. § 1.1001-3. In such cases, it ensures that the Qualifying IBOR Alterations do not transfer value from one party to another in a manner that defeats the change-in-yield test for the OCAs. In theory, absent the Substantial-Equivalence-of-FMV rule, the parties could manipulate the change-in-yield test with respect to the OCAs by providing for off-market Qualified IBOR Alterations that transfer value from one party to the other. Because Qualified IBOR Alterations are excluded from significant modification testing, this transfer of value would not factor into the change-in-yield test applied to the OCAs. It is hard to envision realistic examples where this could or would occur, but the following two examples involving covenant waivers illustrate the conceptual point:

> **Example 2.** Consent payment for covenant waiver. Issuer has outstanding a debt instrument having no OID and providing for interest at 3-month LIBOR plus 200 basis points. The parties agree to relax a financial covenant in the issuer's favor and, in return, the issuer agrees to make a one-time payment referred to as a "consent fee." Under Treas. Reg. § 1.1001-3, the consent payment and covenant change are each a modification that must be tested for significance. The covenant waiver is *per se* not significant.[22] Whether the consent payment is significant depends on whether it trips the change-in-yield test.[23]

21 Treas. Reg. § 1.1001-3(e)(2)

22 Treas. Reg. § 1.1001-3(e)(6).

23 Treas. Reg. § 1.1001-3(e)(2).

Example 3. Covenant waiver and contemporaneous removal of IBOR-referencing rate in lieu of large consent payment. Issuer has outstanding the same debt instrument as in Example 2. The issuer desires a covenant waiver that would normally require the issuer to make a consent payment equal to 10% of the principal amount. Assume that a consent payment of this magnitude would trip the change-in-yield test. While negotiating the covenant waiver, the parties negotiate to replace the IBOR-referencing rate (3-month LIBOR plus 300 basis points) with a new qualifying rate (SOFR plus 500 basis points). The parties choose a higher fixed spread component of the new qualifying rate than would otherwise be necessary had they been negotiating only the replacement of the IBOR-referencing rate. The excess fixed-spread component allows the parties to forgo the 10% consent payment that would otherwise be necessary. In other words, in exchange for a covenant waiver that would normally require the issuer to make a consent payment that would trip the change-in-yield test, the parties compensate the holders through a holder-favorable spread adjustment to the qualified rate. On these facts, the value of the debt instrument immediately after the change in interest rate (but before the covenant waiver) is 110% of the value before.

Absent the Substantial-Equivalence-of-FMV rule, the replacement of the IBOR-referencing rate would qualify under the Proposed Regulations for exclusion from Treas. Reg. § 1.1001-3. The covenant waiver would be tested under Treas. Reg. § 1.1001-3 where it would be *per se* not significant. Further, because there is no consent payment that needs to be tested under Treas. Reg. § 1.1001-3, the change-in-yield test would not be tripped. The Substantial-Equivalence-of-FMV rule prevents this result. Because the FMV immediately after is not substantially equivalent to the FMV immediately before, none of the alterations are Qualifying IBOR Alterations eligible for exclusion from Treas. Reg. § 1.1001-3 testing and therefore all of the alterations must be tested under Treas. Reg. § 1.1001-3. Presumably, the increase in the fixed-spread component of the qualified rate would trip the change-in-yield test, resulting in a significant modification.

The Substantial-Equivalence-of-FMV rule does not appear necessary where (i) the Qualifying IBOR Alterations are the only alterations (that is, there are no OCAs), and (ii) the parties are acting at arm's length. In this case, the FMV of the debt instrument post-alteration must be substantially equivalent to the FMV pre-alteration as the alterations would be the product of arm's length negotiations.

Where the parties are related, the utility of the Substantial-Equivalence-of-FMV rule can be debated. Presumably, most related-party situations involve parties under common control such that section 482 applies. Section 482 affords the IRS broad latitude to adjust the tax treatment of transactions between parties under common control so that the terms resemble those that would be reached by parties acting at arm's length. In the case of a debt instrument between related parties, section 482 allows the IRS to adjust the interest rate where the rate fails to reflect an arm's length rate.[24] An arm's length rate for this purpose includes a rate that would be charged between unrelated parties in similar circumstances (a "***market rate***"),[25] the relevant applicable federal rate ("***AFR***"),[26] and any rate in between a market rate and the AFR.[27] Importantly, the regulations provide that the IRS can adjust the rate of interest only; it cannot adjust the amount loaned.[28] It can be argued that where the rate of interest is set between the AFR and a market rate such that section 482 respects the rate as "arm's length," there is an implication that the FMV of the debt is equal (or deemed equal) to its principal amount.[29] Whether the Substantial-Equivalence-of-FMV rule is necessary for related party debt may turn on one's view of the circumstances in which it is appropriate to infer that the principal amount equals FMV.

Another factor to be weighed in the related party context is the accounting for a debt-for-debt exchange were the Proposed Regulations not to apply. Presumably, related party debt is generally not "traded on an established securities market."[30] Thus, if there were a debt-for-debt exchange, the issue price of the new debt instrument generally would be determined by reference to its principal amount, not its FMV.[31] Where the related parties change the rate to a new rate that is no lower than the AFR and no higher than market, the practical consequences of a debt-for-debt exchange may be slight. Where there is no one-time payment, the holder's amount realized and the issuer's repurchase price would both equal the principal amount of the new debt. So long as the issuer and the holder each were carrying the old debt at its principal amount, neither the issuer nor the holder would have an immediate tax impact upon the exchange.[32]

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[24] Treas. Reg. § 1.482-2(a).

[25] Treas. Reg. § 1.482-2(a)(2)(i).

[26] AFR is defined in Treas. Reg. § 1.482-2(a)(2)(iii)(C) and Treas. Reg. § 1.1275-4(b). AFRs are published by the IRS on a monthly basis and seek to reflect the cost of borrowing funds at specific tenors without regard to credit risk. In the case of variable-rate debt where the interest rate resets not less frequently than annually, the relevant AFR is the short-term AFR. See Treas. Reg. § 1.1275-4(c)(2)(i).

[27] Treas. Reg. § 1.482-2(a)(2)(iii)(B)(*3*). Where 130% of the AFR is greater than a market rate, the range of arm's length rates is bounded by (i) the lower of 100% of the AFR and the market rate on the low end and (ii) 130% of AFR on the high end. Treas. Reg. § 1.482-2(a)(2)(iii)(B)(3).

[28] Treas. Reg. § 1.482-2(a)(3)(i) ("Only the rate of interest with respect to the stated principal amount of the bona fide indebtedness . . . shall be subject to adjustment under section 482.")

[29] The extent to which section 482 can be interpreted to create a presumption that a debt's FMV equals its principal amount is beyond the scope of this report.

[30] Treas. Reg. § 1.1273-2(f).

[31] Sections 1273(b)(4) and 1274. Under Treas. Reg. § 1.1274-2(b)(3), however, the issue price of a debt instrument issued in a "potentially abusive situation," as defined in Treas. Reg. § 1.1274-3, is its FMV.

[32] Where there is a one-time payment from the issuer to the holder that allows the parties to set a stated interest rate below the AFR, the holder's amount realized and the issuer's repurchase price would be the "imputed principal amount" of the debt instrument – an amount less than the principal amount. Specifically, under Treas. Reg. § 1.1274-2(c)(1), the imputed principal amount is the sum of the present values of all payments, including payments of stated interest, at the AFR. In the case of a VRDI that provides for stated interest at a

Related parties may therefore be indifferent to whether the alterations necessary to remove IBOR-referencing rates are Qualifying IBOR Alterations.[33]

We recommend that the Substantial-Equivalence-of-FMV rule be retained with certain changes. First, we recommend that, in the case of unrelated parties, the rule apply only in cases involving both Qualified IBOR Alterations and OCAs. In the case of related parties, we do not have a specific recommendation.

Second, for clarity, we recommend the Substantial-Equivalence-of-FMV rule be de-linked from the definition of QR. Under the Proposed Regulations, the rule is a limitation on the definition of QR. The regulations would be clearer if it were presented as an additional requirement for qualification under the general rule.

Third, consideration ought to be given to aligning the consequence of failing to meet the Substantial-Equivalence-of-FMV test more closely with the purpose of the IBOR-transition rule. As the Proposed Regulations are drafted, failure to meet the test turns off the general rule for alterations that, but for the rule, would be Qualifying IBOR Alterations. The rule's purpose, however, appears limited to ensuring that IBOR-transitioning alterations are not a vehicle for circumventing the normal operation of the change-in-yield test for OCAs. Thus, a more proportionate response would be to treat any change in value created by Qualifying IBOR Alterations as a "payment" solely for purposes of the change-in-yield testing of the OCAs. Under this approach, the Qualifying IBOR Alterations would remain qualifying and the result of the OCA under the change-in-yield test would be the same as it would have been had there been no Qualifying IBOR Alterations.

3. <u>Safe Harbors under Substantial-Equivalence-of-FMV rule</u>

As proposed, the Substantial-Equivalence-of-FMV rule consists of a broad general rule ("any reasonable, consistently applied valuation method") and two safe harbors. Arguably, the broad general rule is all that is necessary.

The historic average rate safe harbor[34] requires a comparison of the historic average of the relevant IBOR-referencing rate and the replacement rate taking into account spreads,

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QFR, the amounts of the interest payments are determined by treating the QFR as being equal to its current rate. *See* Treas. Reg. § 1.1274-2(f)(1),

In this case, the holder's amount realized and the issuer's repurchase price would equal the sum of the imputed principal amount and the one-time payment. This sum could be greater than or less than the principal amount. If so, the difference between such sum and the principal amount would give rise to immediate gain or loss realization to the holder and COD or repurchase premium expense to the issuer.

33 The tax impact of an exchange between related parties where there is a one-time payment is more complex. If the interest rate on the new debt is "adequate" within the meaning of Treas. Reg. § 1.1274-2(b), the issue price of the new debt would be its principal amount. The holder's amount realized and the issuer's repurchase price would each equal the sum of the issue price and the one-time payment. This could result in holder gain and issuer repurchase premium expense equal to the one-time payment. If the alterations are considered Qualifying IBOR Alterations such that there is no debt-for-debt exchange, the parties would account for the one-time payment under the rules for one-time payments discussed below.

34 Prop. Reg. § 1.1001-6(b)(2)(ii)(A).

adjustments to the rates and one-time payments made in connection with the alteration. If the difference between the two historic averages is less than 25 basis points, the safe harbor is met. This safe harbor is helpful where the standard can be met.

It is worth observing that the historic average rate safe harbor may be both underinclusive and overinclusive. It will not cover all cases where the FMV of the debt before and after the alterations is substantially equivalent. Many IBOR-transitions will result in a change in the tenor of the rate. For example, moving from 3-month LIBOR to SOFR is a move from a 90-day rate to an overnight rate. In a positively sloped yield curve environment one would expect the rate to go down due to the changed tenor, possibly more than 25 basis points. This type of change would fall outside the safe harbor but ought not to create an implication that there has been a value shift. Another potential limitation of the usefulness of the historic rate safe harbor is the potential lack of historic look-back data.

The "arm's length negotiation" safe harbor is arguably ambiguous and, if retained, would need to be clarified. It provides that the Substantial-Equivalence-of-FMV rule is satisfied where the parties are not related and

> "the parties determine, based on bona fide, arm's length negotiations between the parties, that the fair market value of the debt instrument or non-debt contract before the alteration or modification described in paragraph (a)(1), (2), or (3) of this section is substantially equivalent to the fair market value after the alteration or modification."[35]

Presumably, the above-quoted language requires the parties to have negotiated (on a bona fide arm's length basis, no less) about the FMV of the hypothetical debt instrument created by the tax fictions of Prop. Reg. § 1.1001-6. The values that must be found to be substantially equivalent are the observable value of the debt before any alterations and the value of a hypothetical debt that has undergone the Qualifying IBOR Alterations but not yet undergone the OCAs. If both parties desire the Qualifying IBOR Alterations to be within Prop. Reg. § 1.1001-6(a), are they adverse enough to conduct bona fide arm's length valuations about a number used only for tax purposes? What amount of negotiation (and more importantly documentation thereof) is necessary?

If the arm's length negotiation safe harbor is retained, a more realistic approach would be for the issuer to make the determination as to the value of the hypothetical post-Qualifying IBOR Alterations, pre-OCA debt instrument, make the determination as to whether this value is substantially equivalent to the pre-transaction value, and disclose the result of this determination process to the holders along the lines of issue price disclosures made in debt-for-debt exchange transactions under Treas. Reg. § 1.1273-2(f)(9).

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[35] Prop. Reg. § 1.1001-6(b)(2)(ii)(B).

4. Definition of Qualified Rate

Consideration should be given to simplifying and clarifying the QR definition.[36] The Proposed Regulations define QR via a 12-item list.[37] The first eight items are specific overnight secured borrowing rates in various currencies. The ninth item is a catch-all for a rate designated by a central bank, monetary authority, or similar institution as an IBOR-replacing rate. The tenth item is the general definition – a QR is a QFR as defined in the VRDI rules and determined without regard to the VRDI-rule limitation on multiples. The eleventh item makes clear that the definition of QR includes a QFR plus a spread and a QFR times a multiplier. The final item is a catch-all authorizing additional rates not otherwise qualifying as QRs to be designated as QRs by the IRS. The Preamble observes that each of the first nine rates on the list is by definition a good QFR for purposes of the VRDI rules and therefore is literally within the scope of the general rule. Item 11 is also unnecessary – a QFR can itself have a fixed spread and while there are multiplier limits to the definition of QFR in the VRDI rules, the cross-reference in item 10 makes clear that those limits are not to apply. Finally, the same-currency limitation of Prop. Reg. § 1.1001-6(b)(3) is also unnecessary as that requirement is already built into the QFR definition in the VRDI rules.

The most straightforward approach would be to simply state Prop. Reg. § 1.1001-6(b)(1)(x) as the general rule. If there is a desire to specifically enumerate the qualified rates enumerated in Prop. Reg. § 1.1001-6(b)(1)(i)-(ix), the regulatory text could be made clearer if, consistent with the Preamble, it identified these as examples of the general rule and not as standalone rules. Similarly, to the extent it is retained, it would be helpful if the regulatory text made clear that Prop. Reg. § 1.1001-6(b)(1)(xi) (addressing fixed spreads and multipliers) is clarifying and restating the general rule as it could otherwise leave the reader with the impression that fixed spreads and multipliers are not already permissible components of a QR.

5. One-time payments

The Proposed Regulations treat a one-time payment made in connection with the replacement of the IBOR-referencing rate as an AA (and therefore as a Qualifying IBOR Alteration) where the one-time payment offsets a change in value that would otherwise result from the replacement of the IBOR-referencing rate with the QR.[38]

a. Surrogates for Spread Adjustments

One-time payments are surrogates for spread adjustments (and vice-versa). Under the Proposed Regulations, the parties are free to "trade" one-time payments for spread adjustments (and vice versa). Under the Proposed Regulations, so long as the FMV immediately after (taking into account any one-time payment) equals the FMV before, the new floating rate (regardless of the amount of its fixed spread component) will qualify as a QR and the one-time payment

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[36] We recommend delinking the Substantial-Equivalence-of-FMV rule from the definition of QR in section III.B.2 (above).

[37] Prop. Reg. § 1.1001-6(b)(1)(i)-(xii).

[38] Prop. Reg. § 1.1001-6(a)(5).

(definitionally there to ensure values match) will qualify as an AA. Together, they will be Qualifying IBOR Alterations. Their interchangeability is illustrated by the examples below.

> **Example 4**. _Spread adjusted in lieu of one-time payment_. Issuer has outstanding debt providing for semiannual interest at 6-month USD LIBOR plus 300 basis points. The debt is traded on an established securities market within the meaning of Treas. Reg. § 1.1273-2(f), and its observed FMV is 100% of its principal amount. The parties desire to substitute a new rate tied to SOFR. Specifically, the parties agree that the new instrument will provide for interest payable on the same 6-month payment dates equal to compounded SOFR over the period plus a spread. Given that daily compounded SOFR is expected to be lower than 6-month LIBOR, the parties determine that an additional spread of 150 basis points is appropriate. The parties agree to replace 6-month USD LIBOR plus 300 with SOFR plus 450 basis points. At the time the changes are negotiated, the parties reasonably expect that, immediately after the exchange, the FMV of the debt will remain 100% of its principal amount. Thus, the Substantial-Equivalence-of-FMV test is met. Under the Proposed Regulations, the alterations would be Qualifying IBOR Alterations excluded from significant modification testing under the general rule.
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> **Example 5**. _One-time payment in lieu of spread adjustment_. Same facts except that the parties decide to keep the fixed spread at 300 basis points so that the rate is changed from 6-month USD LIBOR plus 300 basis points to SOFR plus 300 basis points. The parties negotiate for the issuer to make a one-time payment to the holder (at the time of the rate substitution) equal to 7.00% of the principal amount. The amount of the one-time payment equals the discounted present value of a stream of 150 basis point payments over the remaining term of the debt. Finally, the parties reasonably expect that, immediately after the exchange, the FMV of the debt will be 93% of its principal amount. Because the sum of the 93% FMV and the 7% one-time payment equals the 100% FMV before, the Substantial-Equivalence-of-FMV rule is met. Under the Proposed Regulations, the alterations would be Qualifying IBOR Alterations excluded from significant modification testing under the general rule.
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> **Example 6**. _One-time payment from issuer and reduction in fixed-spread_. Same facts except the parties decide to go from 6-month USD LIBOR plus 300 basis points to SOFR plus 150 basis points. In addition, the parties agree to a one-time payment of 14% of the principal amount. The amount of the one-time payment equals the discounted present value of a stream of 300 basis point payments over the remaining term of the debt. Finally, the parties reasonably

> expect that, immediately after the exchange, the FMV of the debt will be 86% of its principal amount. Because the sum of the 86% FMV and the 14% one-time payment equals the 100% FMV before, the Substantial-Equivalence-of-FMV rule is met. Under the Proposed Regulations, the alterations would be Qualifying IBOR Alterations excluded from significant modification testing under the general rule.

Under the Proposed Regulations, each of these transactions would be within the general rule. In Example 5, the one-time payment adjusts for the fact that the switch from 6-month USD LIBOR to SOFR reduces the expected amount of the future interest payments. Although the adjustment in the holder's favor could have been accomplished by increasing the spread, the Proposed Regulations provide that this type of one-time payment should qualify as an AA.

b. Potential limitation on amount of one-time payment

Example 6 seems qualitatively different and arguably beyond the intended scope of the Proposed Regulations. In this example, the issuer can be viewed as availing itself of Prop. Reg. § 1.1001-6(a)(1) to avoid having to analyze whether the prepayment of otherwise fixed payments results in a significant modification under Treas. Reg. § 1.1001-3. Although the transaction has the feel of being beyond the intended grace of the rule, there may be little practical effect of allowing it to be covered by the Proposed Regulations, especially if, as discussed below, the one-time payment is accounted for as interest that accrues over time (i.e., in the same manner that a spread adjustment would be).

If Example 6 were excluded from Prop. Reg. § 1.1001-6 and therefore analyzed under Treas. Reg. § 1.1001-3, it is unclear whether it would result in a debt-for-debt exchange.[39] If it resulted in a debt-for-debt exchange, the tax impact to a holder would depend on the holder's basis. Each holder would have an amount realized of 100% of the principal amount (14% attributable to the one-time payment and 86% attributable to the issue price of the new debt). Thus, a full-basis holder would realize no gain or loss. A holder having a basis less than the principal amount would realize and recognize gain. If the transaction qualified as a section 368(a)(1)(E) recapitalization, the holder would recognize this gain to the extent of the one-time-payment. In all other cases, the holder would fully recognize the gain.

The consequences to the issuer of a debt-for-debt exchange in Example 6 would depend on the repurchase price of the old debt. The repurchase price would equal 100% of the principal

[39] Three separate significance inquiries would have to be made: (1) an analysis of the change in variable rate from one reference rate to another under the general fact- and --circumstances test of Treas. Reg. § 1.1001-3(e)(1), (2) an analysis of the cash flows of the equivalent fixed-rate debt instruments under the change-in-yield test of Treas. Reg. § 1.1001-3(e)(2), and (3) an analysis of the change in timing of payments under Treas. Reg. § 1.1001-3(e)(3). Presumably, the change from one rate to another would not be significant under the general rule where both are reasonably expected to measure the cost of newly borrowed funds. If the one-time payment is sized appropriately, the change-in-yield test might not be tripped. This leaves the change in timing of payments. One could argue that the one-time payment represents an acceleration that could be analyzed as either a "negative deferral" protected from significance status by the deferral safe harbor of Treas. Reg. § 1.1001-3(e))(3)(ii) or a change in timing outside of the deferral safe harbor and therefore subject to the facts and circumstances test of Treas. Reg. § 1.1001-3(e)(3)(i).

amount (14% attributable to the one-time cash payment and 86% attributable to the issue price of the new debt). Assuming the issuer was carrying the debt liability at 100% of its principal amount (as would normally be the case for debt issued without OID), the issuer would realize neither COD income nor repurchase premium expense.

Finally, upon a debt-for-debt exchange the new debt would have OID of 14% -- an amount of OID equal to the amount of the one-time payment. The holders would include, and the issuer would deduct, the OID over the life of the new debt on constant yield principles.

c. One-time payments where debt is not publicly traded

Where the debt is not traded on an established securities market, the consequences of a debt-for-debt exchange can differ significantly from those under the Proposed Regulations. Consider the following example.

> **Example 7**. One-time payment from issuer and reduction in fixed-spread; debt is not publicly traded. Same facts as Example 6 except the debt instrument is not traded on an established securities market. As in Example 6, the parties change the rate from 6-month USD LIBOR plus 300 basis points to SOFR plus 150 basis points and the issuer makes a one-time payment equal to 14% of the principal amount. As in Example 6, this causes the FMV of the debt to drop from 100% of its principal amount to 86% of its principal amount. Because the sum of the 86% FMV and the 14% one-time payment equals the 100% FMV before, the Substantial-Equivalence-of-FMV rule is met. Under the Proposed Regulations, the alterations in Example 7 would be Qualifying IBOR Alterations excluded from significant modification testing under the general rule.

Under the Proposed Regulations, Example 7 does not result in a debt-for-debt exchange. Assuming the one-time payment is accounted for over the remaining life of the debt as a yield adjustment, Example 7 will not produce an immediate tax item to either party.

In contrast, if the transaction in Example 7 were excluded from the Proposed Regulations, analyzed under Treas. Reg. § 1.1001-3, and determined to result in a debt-for-debt exchange,[40] the holders (but not the issuer) generally would realize and recognize an immediate tax item upon the exchange -- gain attributable to the one-time payment.

The holders' gain recognition results from the fact that in a debt-for-debt exchange where neither the old nor the new debt is publicly traded, the issue price of the new debt is determined by reference to its principal amount, rather than its FMV. Assuming the new rate (SOFR plus 150 basis points) exceeds the short-term AFR, the issue price of the new debt instrument would be 100% of its principal amount, even though the new debt instrument's FMV would equal only

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[40] Example 7 and Example 6 differ only in the status of the debt as traded on an established securities market – a difference that does not factor into an analysis under Treas. Reg. § 1.1001-3. Thus, in Example 7, as in Example 6, it is unclear whether the transaction would give rise to a debt-for-debt exchange. To reach a conclusion, the same three significance inquiries discussed in footnote 39 would need to be undertaken.

86% of its principal amount.[41] Stated another way, the issue price of the new debt instrument would be overstated relative to FMV by 14%. This overstated issue price would lead the holder to have an overstated amount realized. Specifically, the holder's amount realized on the exchange would equal 114% of the principal amount (the sum of the 14% one-time payment and the 100% issue price of the new debt instrument). A full-basis holder (that is, a holder having a basis equal to 100% of the principal amount) would realize and recognize 14% gain. This immediate gain represents an acceleration of what would have been 14% OID had the debt been traded on an established securities market such that its issue price would have been its 86% FMV, as in Example 6.[42]

Notably, the issuer would have a similarly overstated repurchase price but, unlike the holder, this would not result in an acceleration. The issuer's repurchase price, like the holder's amount realized, would be 114% of the principal amount (the sum of the 14% one-time payment and the 100% issue price of the new debt instrument), and therefore, the issuer would realize repurchase premium of 14% (excess of repurchase price over 100% principal amount). Although repurchase premium generally is currently deductible as interest expense, when the repurchase premium arises from a debt-for-debt exchange where the debt is not traded on an established securities market, the repurchase premium must be spread over the term of the new debt instrument as if it were OID.[43] Thus, the issuer would deduct the 14% repurchase premium over the life of the new debt—the same result as that achieved in Example 6 where the debt was traded on an established securities market.

d. Recommendation to limit AA status of one-time payments

We recommend that final regulations limit the qualification of one-time payments as AAs. Specifically, we recommend that one-time payments from the issuer to the holders should be considered AAs only where the fixed spread component of the QR is no smaller than that of the IBOR-referencing rate. Thus, the one-time payment in Example 5 above would constitute an AA but the one-time payments in Examples 6 and 7 would not. To be sure, one-time payments could go the other way – from the holder to the issuer. In that case, to be symmetrical, a one-time payment from the holder to the issuer should be considered an AA only if the fixed-spread component of the QR is no greater than that of the IBOR-referencing rate.

If this limitation is adopted, then, where it applied, absent additional rules, none of the alterations involved in the transaction would be Qualifying IBOR Alterations and therefore the entire set of alterations would have to be tested under Treas. Reg. § 1.1001-3. If the one-time payment was necessary to ensure the value after the alterations equals the value before, its exclusion from AA status will cause the value after to differ from the value before, preventing the Substantial-Equivalence-of-FMV test from being met. In Example 6, half of the 14% one-time payment would be excluded from AA status under this rule. As a result, the value after would be 93% (86% value of debt plus 7% of the one-time payment). This amount is not

41 Treas. Reg. § 1.1274-2(b).

42 On these facts, the holder would be required to recognize the realized gain regardless of whether the debt-for-debt exchange qualifies for nonrecognition as a recapitalization under section 368(a)(1)(E). The one-time payment is "boot" in the exchange.

43 Treas. Reg. § 1.163-7(c).

substantially equivalent to the 100% value before. Thus, none of the alterations would be Qualifying IBOR Alterations.

A more calibrated (but more complicated) approach could preserve the Qualifying IBOR Alteration status of the remaining alterations. One approach would treat the excluded portion of the one-time payment as an AA solely for purposes of the Substantial-Equivalence-of-FMV rule. Returning to Example 6, the FMV after would equal 100% (86% FMV of debt plus the full 14% one-time payment), the same FMV as before, and therefore the Substantial-Equivalent-of-FMV test would be met. Under this approach, the excluded portion of the one-time payment would be treated as an OCA that must be tested for significance under Treas. Reg. § 1.1001-3 and therefore analyzed under both the change-in-yield test and the change-in-timing test. For purposes of the change-in-yield test, the "unmodified instrument" on the date of the modification ought to reflect the Qualifying IBOR Alterations other than the reduction of the fixed spread below the original fixed spread amount. Thus, in Example 6, the unmodified debt instrument would provide for periodic payments at SOFR plus 300 basis points and would have an issue price of 93% (its issue price reflects only the qualifying portion of the 14% prepayment). The hypothetical debt instrument would reflect the full post-alterations terms. In Example 6, it would provide for periodic payments equal to SOFR plus 150 basis points and have an issue price of 86% (100% less the full 14% one-time payment).

e. Tax accounting for one-time payments

Prop. Reg. § 1.1001-6(d) provides that "the source and character" of a one-time payment treated as an AA has the source and character that would "otherwise apply" to a payment made by the payor with respect to the debt instrument or non-debt contract that is altered or modified. The "source and character" rule is silent as to timing.

There are three basic timing approaches – current, deferred, and spread-over-time. Under a "current" approach, a payment from the issuer to the holder could be treated as a current interest expense to the issuer and current interest income to the holder. Under a "deferred" approach, a payment from the issuer to the holder could be treated as reducing both the issuer's amount of liability and the holder's basis. This approach would give rise to future repurchase premium (when the issuer ultimately repays the full principal amount, the issuer would have bond repurchase premium equal to this amount) and future capital gain to the holder. The middle-ground approach is to account for the one-time payment over time as an adjustment to yield. Under this approach, the one-time payment gives rise to what is, in effect, "springing OID."

Arguments can be made in favor of each of the approaches. The current approach has the advantage of administrative ease. The taxable income or expense follows the current cash flow. Where the amounts at issue are relatively small, administrative ease may be the most important factor. The deferral approach is consistent with the IRS's position in PLR 201105016. There, the IRS considered the treatment of a "consent fee" where the modifications were not significant. The IRS treated the fee as a payment that reduces the holder's basis and the issuer's amount of liability. The deferral approach has the disadvantage of being administratively cumbersome in that it does not conform the tax treatment with either cash flows or non-tax intuition.

The spread-over-time approach would be most consistent with the core principle of the time-value provisions of the Code -- that interest income and expense are to be accounted for over the life of the debt on constant yield principles. Consistent with this policy, the time value rules generally treat "prepaid interest" as giving rise to OID – interest that must be taken into account over time. This policy is reflected in authorities such as Rev. Rul. 83-84 (applying clear reflection principles to disregard an uneconomic allocation of interest to time periods), the "points" provision of the regulations that generally treat "prepaid interest" as an adjustment to the amount loaned (creating OID that will be taken into account over the life of the debt rather than current interest income and expense),[44] and the definitions of "qualified stated interest" and OID in Treas. Reg. § 1.1273-2.

Further, the spread-over-time-approach is similar to other rules addressing alterations that do not result in a significant modification.[45] Under such rules, solely for purposes of determining and accruing OID, the debt is treated as retired and reissued on the date of the change for an amount equal to its adjusted issue price (adjusted for one-time payments).[46] Under this approach, a one-time payment from the issuer would reduce the adjusted issue price and thereby give rise to "springing OID" that the parties would accrue over the remaining life of the debt.

We recommend that final regulations adopt the spread-over-time approach. Under the approach, a "prepayment" of the fixed spread does not accelerate income or expense; instead the prepayment reduces the adjusted issue price creating OID that will be taken into account in the same periods that the forgone spread payment would have been taken into account.

C. <u>Non-debt contracts</u>

The Proposed Regulations generally apply to non-debt contracts in the same manner as debt instruments and reach appropriate policy results.

For derivatives, the tax stakes of a deemed exchange under Treas. Reg. § 1.1001-1(a) arising from the removal of an IBOR-referencing rate differ from the tax stakes in the case of debt instruments. Many derivatives are accounted for under the hedge timing rules of Treas. Reg. § 1.446-4 or the mark-to-market rules of section 475 or section 1256. Under these regimes, a party's accounting results do not depend on the presence or absence of realization events and therefore the no-realization-event rule of Prop. Reg. § 1.1001-6 is not directly relevant.

Some derivatives are, however, accounted for under realization principles and provide for payments linked to IBOR-referencing rates. These include total return swaps that are notional principal contracts ("***NPCs***") under Treas. Reg. § 1.446-3, options, and forward contracts. To the extent these derivatives are accounted for on a realization basis, a taxpayer's position in the

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44 Treas. Reg. § 1.1273-2(g).

45 Treas. Reg. § 1.1275-2(j)(deferral that is not a significant modification), Treas. Reg. § 1.1272-2(c)(6)(a change from one alternate payment schedule to another), and Treas. Reg. § 1.1275-2(h)(a change in payment schedule due to a remote or incidental contingency).

46 *Id.*

derivative can reflect significant amounts of unrealized gain or loss – gain or loss that would be triggered upon a deemed exchange under Treas. Reg. § 1.1001-1(a).

> **Example 8**. _Total Return Equity Swap_. Taxpayer enters into a 5-year total-return swap over a referenced publicly-traded stock with a bank. Under the swap, Taxpayer is entitled to periodic cash flows equal to the dividend yield (if any) on a notional amount of the stock and, at maturity, a payment equal to the excess of the maturity-date value of the notional amount of the stock over the initial value of the notional amount. In exchange, Taxpayer is required to make periodic payments equal to 3-month LIBOR plus 100 basis points multiplied by the notional amount and, at maturity, a payment equal to the excess if any of the initial value of the notional amount of the stock over its maturity-date value. Taxpayer's position resembles that of a purchaser of the stock where the purchaser borrowed the purchase price at 3-month LIBOR plus 100 basis points. To the extent the referenced stock has a value different than its initial value, Taxpayer's position in the stock will reflect unrealized gain or loss.

Absent guidance, a modification to the terms of the "financing leg" of the swap that replaces an IBOR-referencing rate with a non-IBOR referencing rate would need to be tested for deemed exchange treatment under Treas. Reg. § 1.1001-1(a), that is, whether the post-modification property "differs materially in kind or extent" as compared with the property pre-modification. If so, there would be a deemed exchange, triggering gain or loss realization on the swap. It can be argued that a change in the "financing" leg from one rate that reasonably measures the cost of newly borrowed funds to another ought not to result in property that differs materially in kind or extent – the "essence" of the contract remains the bet that the referenced stock will return more than the cost of the debt capital to fund it. Stated another way, a change in the specific rate used to measure the cost of debt capital is arguably not a material change where the economic bet is really about the performance of the stock.[47] Absent guidance, however, the conclusion that there has not been a deemed exchange could be challenged given the inherently factual nature of the inquiry and the limited available guidance. Concern over such a challenge could thwart the larger goal of encouraging the transition away from IBOR.

The Proposed Regulations provide the same basic rule for non-debt contracts (including derivatives) that they do for debt – modifications reasonably necessary to remove an IBOR-referencing rate and replace it with a QR do not give rise to a deemed exchange under Treas. Reg. § 1.1001-1(a). The certainty the Proposed Regulations provide on this point is welcome.

As in the case of one-time payments that are AAs with respect to debt, the Proposed Regulations address only "source and character," of "associated modifications" with respect to

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[47] See Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 TAX NOTES 737 (Apr. 29, 2002).

non-debt contracts.[48] We recommend that consideration be given to whether more specific guidance in respect of source and character is warranted.

The Proposed Regulations do not address timing of one-time payments. We believe that timing ought to be addressed generally and, in the case of NPCs at least, specifically. Historically, the treatment of upfront payments with respect to NPCs has been the subject of IRS concern and litigation.[49] The NPC regulations make clear that one-time non-periodic payments with respect to NPCs are to be taken into account over the life of the NPC and not as an item of income or expense when paid or received.[50] We believe that a one-time payment on an NPC ought to be treated as a non-periodic payment and therefore taken into account over the remaining life of the NPC rather than when paid or received.

Consideration could be given to a general catch-all timing rule in Prop. Reg. § 1.1001-6(d) for a one-time payment associated with modifications of non-debt, non-NPC derivatives and contracts. The rule could simply reiterate the general timing principle of the Code – that one-time payments are to be taken into account in a manner that clearly reflects income.[51] In some cases, clear reflection would mandate that the income be spread. In others, it would mandate that the income be taken into account at maturity or settlement. Presumably, there would be few if any cases where clear reflection would mandate one-time payments being taken into account currently given that the one-time payment is, almost by definition, a surrogate for a series of fixed spread payments made over time.

D. Integrated Transactions

1. Background

In certain cases, taxpayers are permitted to tax account for the cash flows from a debt instrument and an associated derivative as if they arose from a single debt instrument. A debt instrument and its associated hedging transaction under these rules are referred to as either a "synthetic debt instrument" or "integrated transaction." Specifically, Treas. Reg. § 1.1275-6 authorizes integrated transaction treatment for a debt instrument and an associated derivative where the net cash flows resemble those of either a plain-vanilla, fixed or floating-rate debt instrument.[52] Treas. Reg. § 1.988-5(a) authorizes integrated transaction treatment for a debt instrument providing for cash flows in one or more currencies and an associated derivative where

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48 Prop. Reg. § 1.1001-6(d).

49 See Notice 89-21 (upfront one-time payments on NPCs must be taken into account over the life of the NPC and not when paid or received*). Merck & Co. v. US*, 652 F.3d 475 (3d Cir. 2011) (sale of right to receive payments under one leg of an NPC treated as a deemed loan).

50 Treas. Reg. § 1.446-3(f).

51 Section 446(a).

52 That is, a debt instrument whose operative payment schedule either (i) is comprised entirely of payments that are fixed in amount, or (ii) is comprised of cash flows that would qualify under Treas. Reg. § 1.1275-5 as a variable-rate debt instrument that pays interest at a QFR. In other words, the net cash flows must either be those of a fixed-rate debt or those of a floating-rate debt whose rate is a QFR – a rate that changes periodically to reflect changes in the cost of newly borrowed funds.

the combined cash flows resemble those of a simple, plain-vanilla fixed or floating-rate debt instrument whose cash flows are in a single currency.

Critically, integration treatment depends on a perfect matching of the cash flows of the hedge with those of the debt instrument. This requirement in hard-wired into the definition of the hedging transactions eligible for integration. A "§ 1.1275-6 hedge" is a financial instrument provided that the combined cash flows of the financial instrument and the qualifying debt instrument "permit the calculation of a yield to maturity . . . or would qualify as a VRDI that pays interest at a QFR."[53] Similarly, a "§ 1.988-5(a) hedge" is a derivative that "when integrated with a qualifying debt instrument permits the calculation of a yield to maturity" in a single currency.[54] The perfect-matching requirement is further confirmed by the rules for IRS identification that allow the IRS to integrate where some slippage in cash flow matching is tolerated.[55]

The regulations provide for special rules where a taxpayer "legs out" of an integrated transaction. A taxpayer is considered to leg out of an integrated transaction where prior to the maturity of the synthetic debt instrument the transaction ceases to qualify for integrated treatment. In general, a transaction can cease to qualify for integrated treatment if the taxpayer disposes of its position in the debt component, the hedge component, or both.[56] A transaction also ceases to qualify for integrated treatment if the cash flows of the debt or hedge component change such that the combined cash flows no longer resemble those of either a fixed-rate debt instrument or a VRDI that provides for interest at a QFR. Upon a leg-out, the taxpayer is generally treated as having disposed of all parts of the integrated transaction, and as a result, realizes and recognizes income, deduction, gain or loss at that time (including exchange gain or loss).[57]

Absent Prop. Reg. § 1.1001-6(c), the removal of an IBOR-referencing term from a debt or derivative component of an integrated transaction could result in a leg-out of the integrated transaction and therefore the recognition of significant immediate gain or loss. The standard for legging-out of an integrated transaction differs from the standard for a "significant modification" of a debt instrument under Treas. Reg. § 1.1001-3. Because integrated transaction treatment requires the cash flows of the debt and derivative to perfectly match, small changes to the terms of a debt instrument or its hedge (such as a change in the dates on which the payments under the debt are made) could result in a leg-out and therefore gain or loss recognition. A similarly small

53 Treas. Reg. § 1.1275-6(b)(2)(i).

54 Treas. Reg. § 1.988-5(a)(4)(i).

55 Treas. Reg. § 1.1275-6(c)(2) (IRS can integrate so long as the combined cash flows are "substantially the same as" those required for taxpayer integration); Treas. Reg. § 1.988-5(a)(8)(iii) (IRS can integrate even if one or more of the requirements for taxpayer-initiated integration are not met so long as the combined cash flows of the qualifying debt instrument and the hedge "in substance" meet the matching requirements).

56 Treas. Reg. §§ 1.1275-6(d)(2)(i) and 1.988-5(a)(6)(ii). Under Treas. Reg. § 1.988-5(a), a simultaneous disposition of both legs constitutes a leg-out; under Treas. Reg. § 1.1275-6, a simultaneous disposition of both legs is treated as a disposition of the synthetic debt instrument and not a leg-out.

57 Under Treas. Reg. § 1.1275-6(d)(2)(ii)(A), the taxpayer is treated as selling or otherwise terminating the synthetic debt instrument for its fair market value, while under Treas. Reg. § 1.988-5(a)(6)(ii)(B) the taxpayer is treated as having sold or otherwise terminated each component of the synthetic debt instrument.

change to a stand-alone debt instrument or stand-alone derivative might not result in a realization event under Treas. Reg. § 1.1001-3 or Treas. Reg. § 1.1001-1(a).

2. Prop. Reg. § 1.1001-6(c)

The Proposed Regulations seek to ensure that changes to the terms of the debt or hedge component of an integrated transaction will not cause a leg out if those changes are reasonably necessary to replace an IBOR-referencing rate. Specifically, Prop. Reg. § 1.1001-6(c) provides that an alteration to the terms of a debt instrument or modification of the terms of a derivative to replace an IBOR-referencing rate with a QR on one or more legs of the transaction is not treated as a legging-out of the transaction if the combined cash flows continue to meet the plain-vanilla fixed or floating rate standard.

This rule is sensible and works well in many cases. Specifically, where there is only one IBOR-referencing rate embedded in the components of the integrated transaction, a replacement of that rate will generally be covered by the proposed rule. For example, consider a contingent payment debt instrument that provides for periodic interest determined by reference to IBOR and a back-end equity-based contingent payment. If the taxpayer enters into a derivative that hedges out the back-end payment, the debt and hedge can be integrated into a simple IBOR-referencing VRDI. A replacement of the IBOR-referencing rate of the debt component would not impact integrated transaction qualification – the combined cash flows would continue to reflect those of a plain-vanilla floating rate debt instrument. Similarly, consider an integrated transaction consisting of a fixed-rate debt instrument and an interest-rate swap where the floating leg is IBOR-based. The integrated transaction would be an IBOR-referencing VRDI. A change of the swap floating rate to one that does not reference IBOR would not impact integrated transaction qualification – the combined cash flows would continue to reflect those of a plain-vanilla floating-rate debt instrument.

The results of the Proposed Regulations are less clear in other cases. Consider the following examples:

> **Example 9:** Synthetic fixed-rate debt instrument. Taxpayer borrows under a debt instrument that provides for interest to be paid semiannually on January 15th and July 15th at 6-month LIBOR plus 100 basis points. Taxpayer enters into a "pay-fixed" interest rate swap having a notional amount equal to the principal amount of the debt and a maturity date equal to the maturity date of the debt. Under the terms of the swap, Taxpayer agrees to make periodic fixed payments equal to the product of 5.00% and the notional amount. In exchange, counterparty agrees to make periodic floating payments equal to the product of 6-month LIBOR and the notional amount. The periodic payments are due each January 15th and July 15th. The combined cash flows resemble those of a fixed-rate borrowing where the taxpayer is obligated to pay interest at the rate of 6.00% (5.00% on the swap plus 1.00% fixed on the debt; the two LIBOR payments net to zero). Taxpayer elects to treat the combined cash

flows as a synthetic fixed-rate borrowing under Treas. Reg. § 1.1275-6.

Example 10: Mismatched reference rates due to change to only one leg. Same facts as Example 9. Taxpayer and holders of the debt negotiate to change the interest rate from 6-month LIBOR plus 100 basis points to SOFR plus 150 basis points. The interest payment dates remain Jan 15th and July 15th. After the change, the combined cash flows resemble those of (i) a fixed-rate debt instrument that provides for 6.00% interest (5.00% under the swap plus 1.00% under the debt) and (ii) a floating-for-floating swap where the Taxpayer pays SOFR plus 50 basis points and receives LIBOR). The floating-for-floating swap measures differences, if any, between LIBOR and SOFR plus 50 basis points. In this case, the combined cash flows are neither those of a fixed-rate debt instrument nor those of a VRDI that provides for interest at a QFR. Although LIBOR and SOFR each would be a QFR on a stand-alone basis, the difference between LIBOR and SOFR is not a QFR.[58] Thus, the change in one leg of the swap arguably causes a "leg-out."

Example 11: Mismatched payment dates due to AAs necessary to implement the change. Taxpayer borrows at a fixed rate and enters into an interest rate swap under which the taxpayer pays floating amounts at 3-month LIBOR with payments to occur on the same day as the borrowing. Taxpayer integrates. Taxpayer changes the swap terms to remove the LIBOR reference and replace it with SOFR plus a spread determined in arrears. Because the SOFR rate is determined in arrears, the quarterly swap payment dates are deferred for 2 days relative to the payment dates under the debt instrument and the original swap. Arguably, the mismatch in payment dates results in a leg-out.

We believe that Examples 10 and 11 ought not to result in leg-outs. In both cases, the change to the underlying item on a standalone basis would have been protected from deemed exchange treatment under the Proposed Regulations. In both cases, there appears to be no policy reason to force a leg-out and therefore immediate recognition of gain or loss. Indeed, treating such slight economic changes as leg-outs arguably frustrates the stated purpose of the Proposed Regulations – to ensure that IBOR transition alterations and modifications do not result in immediate recognition.

The leg-out result in Examples 10 and 11 may not have been intentional. Prop. Reg. § 1.1001-6(c) provides that a change to the debt or the hedge to remove an IBOR-referencing rate:

[58] Treas. Reg. § 1.1275-5(b) defines QFR. The difference between a QFR and a fixed rate is itself a QFR. See Treas. Reg. § 1.1275-5(b)(2)(ii)(a QFR includes a QFR "increased or decreased by a fixed rate"). But, the difference between a QFR and another QFR is not.

> is not treated as a legging-out of the transaction, ***provided that*** the § 1.1275-6 hedge (as defined in § 1.1275-6(b)(2)) or the § 1.988-5(a) hedge (as defined in § 988-5(a)(4)) as modified continues to meet the requirements for a § 1.1275-6 hedge or a § 1.988-5 hedge. (emphasis added).[59]

Under the Proposed Regulations, integrated treatment is thus dependent on the components continuing to qualify as an integrated transaction under existing rules thus defeating the purpose of the Proposed Regulations, as Examples 10 and 11 illustrate.

We recommend that final regulations provide that an integrated transaction will not be considered to have been legged out of merely because one or more of its components was, on a stand-alone basis, altered or modified in a manner protected from deemed exchange treatment under Prop. Reg. § 1.1001-6. Stated another way, if the changes to the standalone components are covered by Prop. Reg. § 1.1001-6, there should be no leg-out of the integrated transaction even if the resulting debt instrument and hedge would not satisfy the hedge definitions if tested after the removal of the IBOR-referencing rate.

If this recommendation is not accepted, final regulations should make clear that minor differences in the two contracts should nonetheless not cause a legging out (e.g., computation of payments in arrears versus in advance or minor mismatches in days on which payments are made). In addition, to address situations where both legs of an integrated transaction need to be modified, final regulations should allow a reasonable time period for taxpayers to change all legs of an integrated transaction (e.g., 30 days plus any additional period of good-faith negotiations between the parties).

E. Arbitrage Investment Restrictions

Treas. Reg. § 1.148-4(h) provides that payments made or received by an issuer under a "qualified hedge" of tax-exempt bonds are taken into account to determine the yield of the issue for purposes of the "arbitrage bond" restrictions. A qualified hedge must meet certain requirements, including that it be entered into primarily to modify the issuer's risk of interest rate changes, that it not have a significant investment element, that it be appropriately sized, and that the payments on the hedge "correspond closely in time" to either the specific payments being hedged on the bonds or pursuant to the bond documents (i.e., a sinking, debt service, or similar fund maintained for the issue of which the hedged bond is a part).[60]

Unlike Treas. Reg. §§ 1.1275-6 and 1.988-5, the arbitrage rules do not require that a specific yield to maturity be capable of being calculated under section 1272 principles. Instead, the rules merely require that the payments "correspond closely in time" to specific payments on the hedged bonds. Accordingly, the requirement that the modified hedge continues to meet the requirements for a qualified hedge under Treas. Reg. § 1.148-4(h) appears to be appropriate.

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[59] Prop. Reg. § 1.1001-6(c).

[60] Treas. Reg. § 1.148-4(h)(2).