Alert

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COZEN O'CONNOR

IRS's LIBOR Fallback Guidance Provides Limited Reissuance Relief to Tax-Exempt Bond Issuers

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BACKGROUND

In 2017, the United Kingdom regulator overseeing the London Interbank Offered Rate (LIBOR), a benchmark for rates for short-term interbank loans, announced that all currency and term variants of LIBOR, including U.S. dollar LIBOR (USD LIBOR), may be phased-out after 2021. In response, the Alternative Reference Rates Committee (ARRC) and the International Swaps and Derivatives Association (ISDA) recommended the Secured Overnight Financing Rate (SOFR) as a replacement for USD LIBOR and the Federal Reserve Bank of New York began publishing SOFR daily rates as of April 3, 2018.

REISSUANCE CONCERNS

Many tax-exempt variable rate bonds, loans and interest based financial contracts such as swaps (which may be integrated for certain purposes with such bonds or loans) contain rates that are based on LIBOR. With the imminent LIBOR phase-out in mind, parties to a LIBOR based instrument may voluntarily, or be required to, modify transaction documents to provide for a transition from a LIBOR rate to an alternate rate or to an alternate fallback rate. The term fallback rate as used herein refers to the provision of an alternative rate, as adjusted by a multiplier, one-time payment and/or spread, if applicable, to govern in the event LIBOR is discontinued. Before making such a modification, it is important to consider the resulting tax consequences, if any. For federal income tax purposes, certain significant modifications, such as changes in interest rates or other changes of economic significance may cause a debt instrument or other financial contract to be deemed "reissued" under Treasury Regulation Section 1.1001-3 or under Treasury Regulation Section 1.1001-1(a) for a non-debt contract. Adverse effects of a tax-exempt bond being reissued may include loss of tax-exempt status, acceleration of rebate payments to the U.S. Department of Treasury (Treasury), application of new tax law requirements, recognition of gain or loss by a holder, loss of integration status between a swap and a debt instrument, and recalculation of bond yield in certain cases. Therefore, consultation with bond counsel is necessary to ensure the manner of replacement of a LIBOR rate with a fallback rate in the documents is not treated as a significant modification to the terms of the tax-exempt bonds, loan or contract, as the transition from a LIBOR rate to a fallback rate may merely be intended by the parties to maintain the preexisting economics.

PROPOSED TREASURY REGULATIONS

In response to the announced LIBOR phase-out, the Treasury and the IRS first issued proposed regulations (namely, Proposed Treasury Regulation §1.1001-6 (Proposed Regulations) on October 9, 2019, allowing the replacement of a LIBOR based rate associated with tax-exempt debt and financial contracts such as swaps with a fallback rate without triggering a reissuance (or a deemed termination in the case of financial contracts) if certain requirements are met. The Proposed Regulations may be applied to modification of the terms of a debt instrument or modification of the terms of a non-debt contract occurring before the Treasury's adoption of final regulations, provided that the Proposed Regulations are consistently applied before such date. Generally, assuming no other significant changes in the documents, the Proposed Regulations provide that if LIBOR is replaced with one of the identified qualified replacement rates in the Proposed Regulations (including SOFR) and such qualified replacement rate, as it may be adjusted by a multiplier, one-time payment and/or spread, does not change the fair market value of the modified instrument (assuming the new rate or the fallback rate, as adjusted, is substantially equivalent), then there is not a modification causing a reissuance under Treasury Regulation Section 1.1001-3 or Treasury Regulation Section 1.1001-1(a) (and for a financial contract such as an interest based swap, there would not be a deemed termination and need for a reintegration of such a swap).

The Proposed Regulations provide two helpful safe harbors for establishing the substantial equivalence of the fallback rate. The first requires the parties to the modified instrument to be unrelated, dealing at arm's length and to determine that the modified and unmodified instruments have a substantially equivalent fair market value, taking into account any one-time payment made in connection with the replacement rate. Although the Proposed Regulations do not require a third-party certification of fair market value, it is uncertain whether some bond counsel may require an independent certification in order to render an unqualified opinion that the establishment of the fallback rate does not create a reissuance. The other safe harbor requires the historic average of LIBOR to not differ by more than 25 basis points from the historic average of the replacement rate, taking into account any spread or other adjustments to each rate, and taking into account any one-time payment made in connection with the replacement.

REVENUE PROCEDURE 2020-44

In another response to the LIBOR phase-out announcement, the Treasury and the IRS issued Revenue Procedure 2020-44 on October 9, 2020. This revenue procedure provides additional protection against reissuance treatment when a bond or a financial contract such as a swap is amended to include LIBOR fallback language published by the ARRC or ISDA.

The revenue procedure is limited to amendments that incorporate the ARRC or ISDA recommended fallback provisions specifically enumerated therein. To benefit from the revenue procedure, the ARRC or ISDA recommended fallback provisions must be adopted "as-is," except for deviations that are reasonably necessary to adopt or to implement the fallback language or to omit terms that cannot under any circumstances affect the operation of the modified contract. Because banks and other holders of LIBOR based tax-exempt obligations may use their own fallback provisions or modify the ARRC or ISDA language beyond the recommended language with only deviations that are reasonably necessary, the revenue procedure may not be helpful in avoiding a reissuance without reliance on Treasury Regulation Section 1.1001-3 or the Proposed Regulations. Additionally, the revenue procedure does not address the critical question of whether the later establishment and implementation of a non-LIBOR based fallback rate as a result of the amendment will be protected from reissuance treatment.

Additional guidance may be forthcoming as the revenue procedure provides that Treasury and the IRS will continue to monitor and evaluate future ARRC and ISDA fallback language and may supplement the enumerated fallback provisions or provide additional relief as necessary to address developments in the transition away from LIBOR.

For assistance or further guidance with implementation of the LIBOR transition with respect to your tax-exempt debt, you are invited to call your regular contact in the Public and Project Finance Practice Group at Cozen O'Connor or Chris Compton at 215.297.2671 or Jerry Spector at 215.665.2039.