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Tax Relief for Replacing LIBOR in Tax-Exempt Debt and Swaps: Orrick

Many tax-exempt bonds and related hedges, such as interest rate swaps (“Exempt Instruments”), use a LIBOR-based interest rate. LIBOR is going away, and existing Exempt Instruments are going to have to be modified to replace the LIBOR index as a result. These changes can result in potentially serious tax consequences relating to a reissuance of the bonds or a deemed termination of the hedge, in addition to the business issues and document requirements that will arise.

On October 8, 2019, the IRS issued proposed regulations (the “Proposed Regulations”) that propose broad relief from these tax consequences. The discussion below focuses on Exempt Instruments, but the Proposed Regulations address replacing any interbank offering rates (IBORs) in any debt instrument or non-debt contract. With some minor limitations, the Proposed Regulations can be applied to IBOR replacements before the final regulations are published.

Potential Tax Consequences of Replacing LIBOR

Prior to the publication of the Proposed Regulations, parties were hesitant to amend existing Exempt Instruments to replace LIBOR-based interest rates, because it was possible that the amendment might trigger a reissuance of tax-exempt bonds or a deemed termination of a related hedge, such as a swap.

If tax-exempt bonds are reissued, the tax treatment is as if the bonds are refunded by new bonds on the date of the reissuance. The new bonds must meet all the requirements for tax-exemption on the reissuance date or the new bonds are not tax-exempt. So long as the law has not changed and certain requirements are satisfied, a reissuance does not usually cause a loss of tax exemption, but that is not the case for other tax-advantaged bonds. For example, the authorization to issue build America bonds (BABs) has expired, and a reissuance of BABs would result in a loss of the subsidy payments to the issuer.

Likewise, if a swap is modified to replace LIBOR with a new index, the swap could cease to meet the requirements for a qualified hedge or could result in a deemed termination of the swap.

The Proposed Regulations provide safe harbors that allow parties to avoid these tax consequences.

In General

The Proposed Regulations provide that amending the terms of an Exempt Instrument to replace LIBOR with a “qualified rate” will not result in a reissuance of the debt instrument or a deemed termination of the hedging contract if the fair market value of the altered Exempt Instrument is substantially equal to the fair market value of the Exempt Instrument prior to being altered. Likewise, any alteration made in association with the replacement (an “associated alteration”) will not trigger a reissuance or deemed termination if a fair market value test is satisfied.

In other words, the actual interest rate (and therefore the arbitrage yield) may change due to the

substitution of the new index, but the bonds are still the same tax-exempt issue and the swap or cap is still a qualified hedge. This will be true regardless of whether the amendments are made through an amendment of the original instrument or by an exchange of a new instrument for the original instrument.

Qualified Rates

The following rates are considered “qualified rates”[1] under the general rule:

- (i) The Secured Overnight Financing Rate published by the Federal Reserve Bank of New York (SOFR);
- (ii) Any qualified floating rate, as defined in §1.1275-5(b) (but without regard to the limitations on multiples), and
- (iii) Any rate that is determined by reference to one of the rates listed above, including a rate determined by adding or subtracting a specified number of basis points to or from the rate or by multiplying the rate by a specified number.

This is a very broad definition of a qualified rate and, subject to the fair market value test, should accommodate almost all desired substitute rate.

Fair Market Value Test

In addition to using a qualified rate, the fair market value of the amended Exempt Instrument must be substantially equivalent to the fair market value before such amendment. The Proposed Regulations provide that the fair market value of an Exempt Instrument may be determined by any reasonable valuation method, as long as that reasonable valuation method is applied consistently and takes into account any one-time payment made in lieu of an adjustment to the index, such as adding basis points. Recognizing that fair market values tests often are difficult to implement, the IRS provided two safe harbors for determining the fair market value.

First Fair Market Value Safe Harbor

Under the first safe harbor, the fair market value test is met if at the time of the alteration the historic average of the LIBOR rate on the Exempt Instrument is within 25 basis points of the historic average of the rate that replaces it. The parties may use any reasonable method to compute a historic average if

- the lookback period from which the historic data are drawn begins no earlier than 10 years before the alteration and ends no earlier than three months before the alteration,
- once a lookback period is established, the historic average must take into account every instance of the relevant rate published during that period, and
- the parties must use the same methodology and lookback period to compute the historic average for each of the rates to be compared.

Although this lookback test is relatively straight-forward, it too may be difficult to implement at times. For example, the Proposed Regulations are silent regarding the minimum length of the lookback period and the minimum number of data points that is acceptable, which raises the question if a lookback period designed to provide one data point would be sufficient. In addition, the Federal Reserve only began publishing SOFR in April 2018, and SOFR is calculated using data from overnight Treasury repo activity, whereas Exempt Instruments often use 30-day LIBOR.

On the other hand, the Proposed Regulations also provide that, for this purpose, an historic average may be determined by using an industry-wide standard, such as a method of determining an historic average recommended by the International Swaps and Derivatives Association (ISDA) for the purpose of computing the spread adjustment on a rate included as a fallback to an IBOR-referencing rate on a derivative or a method of determining an historic average recommended by the Alternative Reference Rates Committee (ARRC) for the purpose of computing the spread adjustment for a rate that replaces an IBOR-referencing rate on a debt instrument. We understand that ISDA and ARRC are working on guidance to assist in determining these historic averages for SOFR.

Second Fair Market Value Safe Harbor

Under the second safe harbor, the fair market value test is met if the parties to the Exempt Instrument are not related, and the parties determine that the fair market value of the amended Exempt Instrument is substantially equivalent to the fair market value of the Exempt Instrument before the amendment. In determining the fair market value of an amended Exempt Instrument, the parties must take into account the value of any one-time payment made in lieu of a spread adjustment (described below). This safe harbor should be satisfied in almost any arms-length rate substitution, but counsel will require certifications to support any opinion. This safe harbor may be the only one that applies if there is a substantial one-time payment.

Associated Alterations

“Associated alterations” are alterations that are both associated with the replacement of the LIBOR-based rate and are reasonably necessary to adopt or implement that replacement. This is also a broad concept. One example of an associated alteration is the requirement for one party to make a one-time payment to the other in connection with the replacement of the LIBOR-based rate to offset the change in value that occurs as a result of the replacement.

Importantly, the Proposed Regulations provide that any such payments have the tax character of the associated instrument. For example such a payment by an issuer to a holder of a tax-exempt bond should be tax-exempt interest. Likewise, a payment from a bondholder to an issuer should be considered additional bond proceeds. It is unlikely that any payments made as a result of associated alterations would be able to be financed on a tax-exempt basis.

Multiple Alterations or Modifications

The Proposed Regulations provide that when alterations or modifications go beyond replacing an IBOR rate and making qualified associated alterations, the excessive portion of the alteration is tested under the normal reissuance rules. The portion of the alteration that is a qualified associated alteration is treated as part of the existing terms of the instrument when the reissuance test is applied. As a result, the qualified associated alteration becomes part of the baseline against which the excess portion of the alteration or modification is tested.

The Proposed Regulations do not address the simultaneous alteration of multiple instruments between the same parties. In such situations, parties may be inclined to maximize a payment made with respect to an Exempt Instrument and to minimize a payment made with respect to other instruments. These circumstances will require careful consideration to make sure that the simultaneous alterations do not result in problems that undermine the tax relief provided by the Proposed Regulations.

Proposed Effective Dates

The IRS has proposed that generally the final regulations ultimately adopted would apply to an alteration of the terms of an Exempt Instrument that occurs on or after the date of publication of the final regulations in the Federal Register. However, a taxpayer may choose to apply certain portions of the Proposed Regulations to alterations that occur before that date, provided that the taxpayer and its related parties consistently apply the Proposed Regulations.

[1] Note that a rate is not a qualified rate if it is in a different currency than the rate being replaced or if the rate is not reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency. This should not matter much for Exempt Instruments, because all such instruments should be US dollar-based. Accordingly, this alert does not discuss qualified rates in other currencies.

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