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Buckle Your Seatbelts: Tax Ramifications of the LIBOR Transition - Arent Fox

Although this article is focused on tax-exempt debt, the tax ramifications of the LIBOR transition are not limited to the municipal finance world, and the elimination of LIBOR may also have a significant impact on taxable debt, interest swap transactions and other transactions utilizing LIBOR.

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General

In connection with LIBOR's impending demise, it became clear to many tax lawyers that numerous tax-exempt bond transactions face the risk of adverse tax consequences because the documents under which they were issued do not contemplate this transition and, therefore, must be amended to provide for a replacement ("fallback") index. This risk arises as a result of a basic tax principle – when a debt instrument is modified in a significant manner after it is issued, the debt is deemed exchanged for a new debt instrument. This exchange, or 'reissuance,' can trigger a tax recognition event to the borrower or bondholder (sometimes a bank or other institutional lender) and, if certain facts are present, may cause tax-exempt debt to lose its tax-exempt treatment under the Internal Revenue Code.

IRS Rev. Proc. 2020-44

General

Following the announcement that LIBOR would be phased out, the Internal Revenue Service (IRS) issued Revenue Procedure 2020-44 aiming to: (1) facilitate the use of alternative reference rates recommended by (a) the Alternative Reference Rates Committee (ARRC) and (b) the International Swaps and Dealers Association (ISDA); and (2) provide that if adequate fallback language is used in loan agreements, the result will prevent a reissuance. The Rev. Proc. attempted to achieve this beneficial outcome by providing that the change in yield that results from the effectiveness of an appropriate alternative rate index would not itself be material, thus treating the effectiveness of such a fallback index as not a taxable exchange of property for other property differing materially in kind or extent for purposes of Treasury Regulation §1.1001-1(a).

Substantially Equivalent Value Test

Tax-Exempt Bond Rule

For municipal bonds, under existing regulations, changes to the terms of a tax-exempt bond transaction are not in themselves considered significant enough to trigger a reissuance if they result in a change in the yield on the bonds of less than 25 basis points. Rev. Proc. 2020-44 increases the circumstances in which this safe harbor applies to certain changes made to accommodate the end of LIBOR.

General Debt Instruments

The general rule under Rev. Proc. 2020-44 is that implementation of certain provisions in documents to replace LIBOR with a new benchmark index will not, by itself, result in reissuance because of the resultant changes in yield without regard to the 25 basis point rule if the fair market value of the altered instrument is substantially equivalent to the fair market value of the unaltered instrument. Given that LIBOR will cease to exist and, thus, there will be no way to measure a replacement index against LIBOR, and given that SOFR and many other replacement indices have not been in existence for long enough to predict their relationship to LIBOR in all interest rate environments, it is unclear how this equivalence requirement can practically be satisfied.

Accordingly, in many transactions we have asked, on behalf of our borrower clients, that a substantially equivalent test be used in amendments to debt instruments contemplating the LIBOR transition. However, banks have been very resistant to this suggestion because of (i) market uncertainty, (ii) lack of history with SOFR and many other replacement indices, and (iii) bank desire to control the rate setting process in connection with the LIBOR transition.

Rev. Proc. 2020-44 attempts to address this problem since it provides that the fair market value may be determined by any reasonable valuation method so long as that method is applied consistently. The question will then be whether a bank's sole discretion in setting of the new interest rate is a reasonable valuation method even if it is done consistently by each bank and consistently within the financial industry.

Integrated Hedges

While Rev. Proc. 2020-44 gives some relief in municipal bond transactions, it is also important to consider how the end of LIBOR will impact transactions that utilize hedges and, specifically, 'integrated hedges.'A debt instrument may be 'integrated' with a hedge for purposes of determining the yield on an instrument for tax purposes, and the amount and timing of taxpayer income, deduction, gain or loss if certain procedures are followed. When amending debt instruments to address the elimination of LIBOR, if an integrated hedge is not simultaneously amended in the same manner, the change to the debt instrument could itself qualify for exclusion from the reissuance rule but the transaction could still lose the benefit of the integrated hedge, and thus be treated as reissued nonetheless. This could lead to potentially unfavorable tax consequences.

The key to avoiding this tax risk will be amending the debt instrument and the hedge in the same manner and at the same time to deal with the LIBOR transition. However, interest rate hedge transactions are generally governed by ISDA documentation, whereas the changes to a debt instrument are dictated by agreements of the parties to the debt instrument – typically the issuer/borrower and the bank/lender. Matching the provisions adopted in contemplation of the phase-out of LIBOR in integrated transactions may be difficult, but may also be critical to avoid adverse tax consequences.

Dichotomy of Fallback Provisions

ARRC

No Recommended Benchmark

ARRC initially announced that the Secured Overnight Financing Rate (SOFR) would be its recommended new interest rate benchmark index for formerly LIBOR-based debt. However, ARRC subsequently announced that banks could utilize any interest rate benchmark they so choose. In the face of this revised ARRC announcement, most banks that we have dealt with that have confronted the LIBOR transition issue have, so far, proposed as a fallback solution that the bank would use a replacement index chosen in the bank's sole and absolute discretion, without any input from the borrower/issuer.

In most cases, under existing regulations and notwithstanding the Rev. Proc. 2020-44 safe harbor, when banks unilaterally choose the new benchmark in a variable rate financing prepayable at any time, a reissuance event could result. Thus, these unilateral pronouncements may fail to allow the lenders to take advantage of the favorable tax treatment (avoidance of reissuance) intended to be available under Rev. Proc. 2020-44 because, absent the safe harbor treatment offered by the Rev. Proc., it is impossible to predict whether the 25 basis point safe harbor will be met now for these benchmark replacement substitutions.

No Recommended Spread Adjustment

Even when SOFR (or an alternative benchmark) is utilized as a replacement index for LIBOR (thus securing Rev. Proc. 2020-44 safe harbor treatment), it is clear that a spread must be added to SOFR for it to yield effective interest rates similar to LIBOR prior to the transition. Although it has tried several times, ARRC has not developed a recommended spread adjustment. In light of this, and absent negotiations, bank transition documentation often state that the new recommended benchmark spread adjustment to equate LIBOR with the new benchmark is to be chosen in the bank's sole and absolute discretion, without any input from the borrower/issuer. This also will likely result in reissuance.

Fair Recommended Fallback Language

ARRC has published recommended fallback language to be used in loan agreements as well as in many other commercial agreements. However, our experience has shown that very few financial institutions are using the ARRC recommended fallback language.

ISDA

Required Fallback

For swaps and derivatives, ISDA has developed what some consider to be a more robust fallback language to specify the rate to be used upon a LIBOR cessation. Although the use of the ISDA fallback may be the scenario expected by the swap counterparties, it is not automatically effective in pre-existing swaps. Therefore, issuers and borrowers must either agree to adopt the ISDA fallback in existing swaps, or amend or replace existing swaps or other derivatives with other new bilateral agreements.

Required Response

In our view, entering into a new agreement or new amendment in the case of swaps facing the end of LIBOR without built-in fallbacks (currently, silence is the most common fact pattern), rather than just agreeing to the ISDA Protocol, is highly recommended, as the ISDA Protocol leaves, at the sole and absolute discretion of the bank: (i) the determination of the new benchmark index, and (ii) the timing of the LIBOR transition. In addition, the ISDA Protocol locks in the benchmark spread adjustment as of March 5, 2021, which may (or may not) be a fair spread adjustment today, much less a year from now. Further, the ISDA Protocol strips away certain existing legal rights of borrowers. Moreover, as noted above, harmonizing these changes with changes to the underlying debt instrument (and vice versa) may also be crucial.

Further Analyses

General

As noted, reissuance, with its potential adverse tax consequences, can be triggered by: (i) changes in the benchmark index referenced from LIBOR to SOFR (or another benchmark as the banks have not eagerly adopted SOFR) together with a benchmark spread adjustment that do not satisfy the requirements of Rev. Proc. 2020-44, and (ii) changes in the other fallback provisions (e.g., interest payment and calculation periods) which are innocuously referenced to as 'conforming changes.'

These changes could constitute an alteration of the terms of a debt instrument, be treated as a significant modification, trigger a tax realization event and, in some cases, result in a loss of tax exemption. Therefore, if borrowers and their lenders are to develop truly helpful LIBOR replacement fallback provisions, a main objective must be to avoid reissuance, which neither the ISDA nor the ARRC language achieves.

Associated Alterations

Rev. Proc. 2020-44 gives relatively broad protection from reissuance treatment for what are termed "associated alterations" done in connection with the change of the reference rate. It further permits, without causing reissuance, a one-time payment to correlate the old fair market value with the new fair market value, in the event an adjustment to the spread or to the rate is not enough to make the debt instruments economically substantially equivalent immediately prior to, and subsequent to, the LIBOR transition. Again, how this will be satisfied is not enumerated in the Rev. Proc. and remains unclear.

Conclusion

Accordingly, borrowers should take particular note of the tax risks summarized here and not merely accept bank proposed changes, particularly because in most bank documents, a change in taxes or regulatory requirements for a particular loan that have negative consequences to the bank are passed on to the borrower.

In a similar vein, in many transactions on behalf of our borrower clients, we have requested that negative implications to the end of LIBOR be retained by the bank, in no small part because (i) this LIBOR transition is taking place as a result of bank manipulations of LIBOR and not from any actions of borrowers and (ii) of the banks' insistence on unilateral decision-making on alternative index and spread selection causing tax risk not created by the borrower. As with other suggested changes to the 'industry-standard' documentation, this position has not been generally accepted by the banks, though it would keep the issuers/borrowers in a similar economic position pre- and post-LIBOR transition.

Consequently, all LIBOR transition documentation should be carefully analyzed prior to execution, even if represented as 'industry-standard,' so as to avoid, among other things, adverse tax consequences borne by the borrower.

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