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Treasury Department Issues Proposed LIBOR Transition Guidance: Implications for Public Finance Community and Muni Issuers

On October 9, 2019 the Department of the Treasury released proposed regulations, Guidance on the Transition from Interbank Offered Rates to Other Reference Rates, 84 Fed. Reg. 54068 (the "Proposed Regulations") to address, among other matters, debt reissuance concerns presented by the upcoming LIBOR transition. These Proposed Regulations contain important changes for issuers and investors in the public finance and municipal capital markets. Kutak Rock's public finance tax group is studying the Proposed Regulations and has prepared this client alert to help you understand and prepare for these possible changes.

In July of 2017 the UK's Financial Conduct Authority announced that it would phase out publication of the London Interbank Offered Rate ("LIBOR") after 2021. (LIBOR is offered in multiple currencies and maturities, for simplicity they are all referred to here as LIBOR.) A significant amount of the muni marketplace consists of bonds or other obligations whose interest rates are set in reference to the LIBOR benchmark as well as associated swaps and other derivatives. As the marketplace has continued to consider the upcoming LIBOR phase out, regulatory bodies in different countries have attempted to design replacements for the benchmark and a process to manage the transition. In the US, the Alternative Reference Rates Committee has proposed the Secured Overnight Financing Rate ("SOFR") as a replacement for LIBOR.

From a tax perspective, the replacement of LIBOR with another interest rate, including SOFR and others, for a municipal bond issuance could result in a determination that the bonds with the LIBOR rate have been exchanged and reissued for bonds with a SOFR rate. This determination could have negative tax consequences for issuers and investors in muni obligations including potential recognition of gain or loss upon the exchange and reissuance, complications complying with applicable arbitrage restrictions, the loss of low-income housing tax credits in multifamily housing deals financed with a bond issue, or even, in rare cases, the potential loss of tax-exempt status entirely. The Proposed Regulations are an attempt by the Treasury Department to minimize potential market disruption and to facilitate an orderly transition from LIBOR to alternative rate setting mechanisms. The Proposed Regulations cover a number of substantive tax areas, some of which are outside the ambit of this notice.

Of greatest importance to participants in the muni marketplace is the addition of Treas. Reg. § 1.1001-6, which provides that:

- Alteration of a bond or debt instrument, or any non-debt contract like a swap, to replace LIBOR with a "qualified rate," or to provide or amend fallback language for transition from LIBOR to a "qualified rate" is not a modification of the debt instrument and therefore will not result in a reissuance.
    - A "qualified rate" includes any of eight enumerated rates, including SOFR, or rates determined by adding or subtracting a spread to the enumerated rates or multiplying the rate by some factor.
    - Certain rates designated by central banks and monetary authorities for LIBOR replacement may be "qualified rates."

- Qualified floating rates under Treas. Reg. § 1.1275-5(b) may be "qualified rates."
- Any rate that the IRS identifies in published guidance is a "qualified rate."

- In addition, the modified instrument must have a "substantially equivalent fair market value" to the original instrument. Parties may use any reasonable, consistently applied valuation method to measure the fair market value but must take into account any one-time payments made in connection with the amendment.
  - There is a safe harbor for the establishment of the substantial equivalence of the fair market value of the instrument before and after amendment as long as the historic average of the replacement rate and the historic average of LIBOR do not differ by more than 25 basis points. The Proposed Regulations also contain requirements on how to measure the historic averages.
  - There is another safe harbor if the parties to an obligation determine that the fair market value of the instrument as amended is substantially equivalent to the original instrument as a result of bona fide, arm's length negotiation between unrelated parties.
- A modified interest rate constitutes a "qualified rate" only if it is based on transactions conducted in the same currency as the original instrument.
- Associated alterations of debt instruments and associated modifications of non-debt contracts will not result in a reissuance either.
  - An associated alteration or modification is one that is done in connection with the replacement of LIBOR or the addition or modification of a LIBOR fallback provision and that is "reasonably necessary to adopt or implement that replacement or inclusion."
  - Examples given include technical or administrative changes, the timing or frequency of setting interest rates, or the obligation of one party to make a one-time payment to offset the change in value of the rates.
  - Other changes to the modified instruments will be measured under the existing reissuance regulations.
- If a swap is modified in the same way as a bond or debt instrument to replace LIBOR with a qualified rate that has a substantially equivalent fair market value, then the swap will not be deemed terminated for arbitrage purposes, provided that the modified swap otherwise meets the requirements in the arbitrage regulations for continued integration with the related tax-exempt obligation.
- One-time payments made in connection with the modifications discussed above have the same character and source as the regular payments made on the obligations.

In addition to the new reissuance regulation described above, the Proposed Regulations address related matters concerning contingent payment debt instruments, the treatment of OID on variable rate debt instruments, and certain requirements for REMICs and foreign corporations.

The Proposed Regulations will be effective upon publication as a final rule in the Federal Register, however taxpayers may choose to apply these rules starting from October 9, 2019 as long as they do so consistently.

Additional Information

Kutak Rock's public finance tax group will be studying the Proposed Regulations and will have more guidance forthcoming as the Proposed Regulations are subject to public comment and possible change before being finalized. If you have any questions regarding the impact of LIBOR transition in the public finance and muni marketplace, any of the below members of Kutak Rock's Section 103 Tax Group are available to answer them at the points of contact below.

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