LIBOR Transition Tax Issues

LIBOR is a key benchmark interest rate underlying many financial contracts. At the end of 2021, a number of LIBOR settings, including those denominated in euros, pound sterling (GBP), Japanese yen, Swiss franc, as well as one-week and two-month US dollar (USD) LIBOR rates, were published for the last time.

By June 2023, the remaining USD LIBOR tenors (one-month, three-month, six-month, and 12-month USD LIBOR rates) will be phased out and replaced by a variety of alternative reference rates. In the U.S., the Alternative Reference Rates Committee, assembled by the Federal Reserve, has selected the Secured Overnight Financing Rate ("SOFR") as the preferred alternative reference rate to USD LIBOR. Other national regulators have made their own choices of preferred replacement rates, e.g., the Sterling Overnight Interbank Average Rate (SONIA) for GBP LIBOR.

In connection with updating contracts to reflect a new reference rate, capital market participants must consider whether there are tax consequences arising from the amendment.

Background

Changing the interest rate index referenced in a financial instrument from LIBOR to SOFR (or another reference rate), or adding fallback language that changes the index at a later date, could result in a deemed taxable exchange of the old contract for the new contract. This deemed exchange could result in the recognition of gain or loss amongst other potential consequences. In 2019, the IRS issued proposed regulations under which a change that replaced LIBOR with a "qualified rate" (such as SOFR) would not trigger a taxable exchange as long as certain conditions were met. Late in 2020, the IRS issued additional guidance in the form of Rev. Proc. 2020-44 dealing with certain modifications adopting fallback language. On December 30, 2021, the IRS published final regulations under Treas. Reg. 1.1001-6 that superseded the 2019 proposed regulations (the "Final Regulations"). Under the Final Regulations, a modification that replaces LIBOR with a "qualified rate" (such as SOFR) will not trigger a taxable exchange if it is a "covered modification". A modification is generally a covered modification if it satisfies the following three requirements:

- The amendment adopts a "qualified rate" that replaces a "discontinued IBOR," or includes a qualified rate in a fallback provision that replaces a discontinued IBOR at a later date (the Final Regulations provide a list of qualified rates, which include SOFR, SONIA, Prime, and Fed Funds);
- The new rate and the old rate must generally be based on transactions conducted in the same currency; and
- The amendment is not an "excluded modification" within the meaning of the Final Regulations.

While the Final Regulations provide clearer guidance, there remain certain complexities, and potential tax pitfalls, in the application of the rules. Practical challenges also should be considered, such as restrictions imposed by current systems and processes used to price and monitor financial transactions. In addition, transfer pricing methodologies and documentation requirements will need to be robust for related party transactions.

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Preparing for the end of LIBOR should include the following steps:

Phase 1: Identify
Establish (or leverage existing) processes and procedures to identify all LIBOR-based products. These can include affiliate and external lending arrangements (including residential and commercial mortgages and other loans), leases, procurement contracts, derivatives, preferred equity, and late payment penalty provisions in any contract.

Phase 2: Categorize
Categorize LIBOR-based products by the level of tax impact. Different categories of LIBOR-based products may present different tax risks and opportunities, while others may be tax neutral. Tax, as an important stakeholder, should get involved immediately, to confirm the tax considerations are balanced against other ramifications.

Phase 3: Resolve
Once the universe of LIBOR-based products has been identified and categorized, taxpayers should develop efficient strategies to make the transition away from LIBOR in a way that aligns the relevant tax considerations with operational concerns and other enterprise strategic goals. Such strategies may involve:

- taking advantage of the Final Regulations and other guidance to avoid a taxable exchange;
- evaluating consistency of your modifications with the directions from relevant financial regulators;
- considering the available choices for replacement rates, calculation of spread adjustments, and other important factors;
- assessing other modifications to LIBOR-based products that would not trigger negative tax consequences;
- considering foreign jurisdiction rules and practices on any needed amendments, including tax and regulatory transfer pricing requirements (as relevant);
- complying with any applicable tax information reporting obligations.

How can we help?
In conjunction with our Advisory team, KPMG Washington National Tax can help you with each of the above three phases. From start to finish, we can work with you and your LIBOR replacement team to enable a smooth and tax-efficient transition away from LIBOR. Please also see our Top 10 FAQs.

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LIBOR Transition and the Tax issues - Top 10 FAQs

01 Is the transition away from LIBOR a taxable event?

Possibly. Whether the Final Regulations or Rev. Proc. 2020-44 preclude a taxable exchange (from a U.S. perspective) depends on the facts and circumstances.

02 Can a consent fee be paid to make an amendment?

Under the Final Regulations, a consent fee is an excluded modification, which would need to be tested under existing law and may trigger a taxable event.

03 What are the tax consequences of a one-time payment?

The Final Regulations allow for a "qualified one-time payment" to compensate a party or parties for changes in value of the contract associated with replacing the interest rate benchmark. The Final Regulations also permit "associated modifications" to be made to the instrument, without triggering a reissuance or deemed exchange. This includes incidental cash payments intended to compensate a counterparty for small valuation differences resulting from a modification of the administrative terms of the contract (e.g., change in observation period). The Final Regulations do not provide guidance as to how parties should tax account for such payments.

04 Are other changes to the instrument permissible?

Generally, changes unrelated to the LIBOR transition will be tested under existing law and may trigger a taxable event.

05 What happens to a derivative that hedges a debt instrument that is subject to the LIBOR transition?

The tax treatment will depend on the facts and circumstances, including whether the derivative was properly identified or integrated as a hedge for tax purposes. The Final Regulations provide that a covered modification of either a hedging transaction or the hedged item is not treated as an exchange of property for other property differing materially in kind or in extent for purposes of Treas. Reg. 1.1001-1(a).

06 Are there any tax issues if my LIBOR-based products are marked to market?

Possibly yes, depending on the facts and circumstances. In addition, certain tax information reporting obligations may still apply.

07 What happens if I adhere to ISDA Protocol for derivatives?

It depends on the provisions of the specific protocol and the negotiations that take place around it. The Final Regulations as well as Rev. Proc. 2020-44 state that contracts that are modified to incorporate an ISDA Fallback that uses the "hardwired approach" will not undergo a taxable exchange.

08 Do the same rules apply if the loan references a rate other than SOFR (e.g., Fed Funds or Prime)?

Under the Final Regulations, a transition from a discontinued IBOR to Fed Funds or Prime may qualify for nonrecognition treatment if the currency requirement and excluded modification requirement are also met. Other replacement rates include and are not limited to AMERIBOR, Bloomberg Short Term Bank Yield Index ("BSBY"), and Sterling Overnight Interbank Average Rate ("SONIA").

09 Can I amend a loan now to make the transition away from LIBOR automatic?

Yes. The Final Regulations allow for an amendment to include a qualified rate through the incorporation of fallback provisions. The incorporation of a fallback provision satisfies one of the three covered modification requirements mentioned above.

10 Are there any tax information reporting obligations associated with LIBOR replacement?

Depending on the facts and circumstances, reporting on Form 1099 or 1042-S may be required. In addition, for related-party instruments, country transfer pricing reporting requirements come into play. Finally, if there is a taxable exchange, the amended instrument may not remain grandfathered under FATCA or §871(m).

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