November 25, 2019

CC:PA:LPD:PR (REG-118784-18)
Room 5203, Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on Proposed Regulations (REG-118784-18), Guidance on the Transition from Interbank Offered Rates to Other Reference Rates

Dear Sir/Madam:

The Structured Finance Association ("**SFA**") respectfully submits this letter in response to proposed regulations (REG-118784-18), "Guidance on the Transition from Interbank Offered Rates to Other Reference Rates," published by the Department of Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") in the Federal Register on October 9, 2019 (the "**Proposed Regulations**"). SFA represents over 360 members from all sectors of the securitization market, and our core mission is to support a robust and liquid securitization market. SFA provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. In balancing the interests of our diverse membership, SFA values consistency and clarity across applicable regulations and welcomes the opportunity to provide feedback on the Proposal.

The Proposed Regulations provide guidance on the tax consequences of the transition to the use of reference rates other than interbank offered rates ("**IBORs**") in debt instruments and non-debt contracts. Treasury and the IRS have indicated that the Proposed Regulations are "necessary to address the possibility that an alteration of the terms of a debt instrument or a modification of the terms of other types of contracts to replace an IBOR to which the terms of the debt instrument or other contract refers with a new reference rate could result in the realization of income, deduction, gain, or loss for Federal income tax purposes or could result in other tax consequences."

Pursuant to the Proposed Regulations, an alteration of the terms of a debt instrument to replace a rate referencing an IBOR with a "qualified rate" and any "associated alteration" is not treated as a modification, and therefore does not result in an exchange of the debt instrument for purposes of Treas. Reg. § 1.1001-3. Similarly, pursuant to the Proposed Regulations, a

modification of the terms of a non-debt contract to replace a rate referencing an IBOR with a "qualified rate" and any "associated modification" is not treated as a deemed exchange of property for other property differing materially in kind or extent for purposes for purposes of Treas. Reg. § 1.1001-1(a).

The Proposed Regulations also provide that an alteration of the terms of a debt instrument or non-debt contract to include a qualified rate as a fallback to a rate referencing an IBOR and any associated alteration are not treated as modifications. In addition, an alteration of the terms of a debt instrument or non-debt contract to substitute a qualified rate in place of a rate referencing an IBOR as a fallback to another rate and any associated alteration are not treated as modifications.

The Proposed Regulations request comments on "any complications under any section of the Code or existing regulations that may arise from the replacement of an IBOR with a qualified rate and that are not resolved in these proposed regulations."

SFA recognizes the difficulty involved in drafting proposed regulations that provide guidance on market uncertainties related to the anticipated replacement of IBOR-based interest rates, and we appreciate Treasury's and the IRS's consideration of these issues.

Per Treasury's and the IRS's request for comments, SFA has several principal recommendations related to the Proposed Regulations and other complications that may arise from the transition from IBOR to a qualified rate. Part I begins with a brief discussion of the portions of the Proposed Regulations relevant to our recommendations. Part II addresses SFA's recommendations in five sections:[1]

A. Further clarification that the activation of fallback rates will avoid taxable exchange treatment under Section 1001 of the Code;

B. Clarification of the application of the Substantial Equivalence Requirement in Prop. Treas. Reg. § 1.1001-6(b)(2), including the application of the Historical Average Safe Harbor and the Arm's Length Safe Harbor;

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[1] In addition to our detailed recommendations for the final regulations discussed below, it would be helpful if the Preamble to the final regulations could provide clarity on the effective date of the Proposed Regulations. Specifically, the Proposed Regulations are permitted to be relied upon, provided that a taxpayer and its related parties consistently apply the regulations. In a securitization transaction, a particular party to one transaction may play a different role in another transaction (i.e., an issuer in one transaction and a trustee in another). It would be helpful if the Preamble to the final regulations could state that the Proposed Regulations were permitted to be relied on as long as a taxpayer and its related parties consistently applied the regulations where the taxpayer was either an issuer or holder.

C. Clarification on the application of the Substantial Equivalence Requirement to one-time payments;

D. Further clarification on the character and source of one-time payments, specifically: (a) explicitly providing that one-time payments by U.S. issuers are exempt from U.S. federal withholding tax; and (ii) whether the payment is treated first as payment of accrued interest and then as a return of principal, or whether the payment would be accounted for as OID over the remaining post-transition term of the instrument; and

E. Further clarification regarding REMICs.

I. Overview of the Proposed Regulations

A. Qualifying Rate and the Substantial Equivalence Test

Prop. Treas. Reg. § 1.1001–6 provides that if the terms of a debt instrument are altered to replace, or to provide a fallback to, an IBOR-referencing rate with a "qualified rate," the alteration is not treated as a modification and, therefore, does not result in the deemed exchange of the pre-altered debt instrument for the new post-altered debt instrument. This same rule applies to ''associated alterations,'' which are alterations that are both associated with the replacement of, or inclusion of a fallback to, the IBOR-referencing rate and reasonably necessary to adopt or to implement that replacement or inclusion.[2] Accordingly, the Prop. Treas. Reg. clearly provides that the adoption of a fallback rate is not a modification of a debt instrument. And if the activation of such fallback rate is treated as an *associated alteration,* the triggering of such fallback rate would also not constitute a modification.

For a replacement or fallback rate to be a "qualified rate" under the Proposed Regulations, (1) the rate must fall within one of the enumerated categories of rates that can be qualified rates, and (2) the fair market value of the instrument after the modification or alteration must be substantially equivalent to the fair market value of the instrument before the modification or alteration (the "**Substantial Equivalence Requirement**").

In determining fair market value for purposes of the Substantial Equivalence Requirement, the parties to an instrument can use any reasonable, consistently applied valuation method and must take into account the value of any one-time payment that is made in connection with the

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[2]The general rule is found in Prop. Treas. Reg. § 1.1001-6(a)(1) and fallback rates are addressed in Prop. Treas. Reg. § 1.1001-6(a)(3). Associated alterations are addressed in Prop. Treas. Reg. § 1.1001-6(a)(5) and qualified rates are addressed in Prop. Treas. Reg. § 1.1001-6(b).

For ease of discussion only replacement of IBOR-referencing debt instruments is addressed. Similar rules apply to, and similar concerns arise with, non-debt instruments. See Prop. Treas. Reg. § 1.1001-6(a)(2).

alteration or modification. A reasonable valuation method may, but does not have to, be based in whole or in part on past or projected values of the relevant rate. The Proposed Regulations provide two safe harbors for the Substantial Equivalence Requirement.

First, a modification or alteration satisfies the Substantial Equivalence Requirement if the historical average of the relevant IBOR rate does not differ by more than 25 basis points from the historical average of the replacement rate, taking into account any spread or other adjustment to the rate, and adjusted to take into account any one-time payment that is made in connection with the alteration or modification (the "**Historical Average Safe Harbor**").

Second, a modification or alteration satisfies the Substantial Equivalence Requirement if the parties to the instrument are not related and the parties determine, based on bona fide, arm's length negotiations between the parties, that the fair market value of the instrument after the modification or alteration is substantially equivalent to the fair market value of the instrument before the change (again, taking into account any one-time payment that is made in connection with the change) (the "**Arm's Length Safe Harbor**").

B. Character and Source of One-Time Payments

The Proposed Regulations recognize that an alteration of a debt instrument in connection with a transition from an IBOR-based rate to a new qualified rate may require the issuer to make a one-time payment to the holder to offset the change in value of the instrument that would result from adopting the new rate. Under Prop. Treas. Reg. § 1.1001-6(d), the source and character of any such one-time payment is "the same as the source and character that would otherwise apply to a payment made by the payor with respect to the debt instrument."

C. REMIC Qualification

The Proposed Regulations recognize that an alteration of a REMIC regular interest in connection with a transition from an IBOR-based rate to a new qualified rate could, absent guidance, cause a REMIC to fail to qualify as a REMIC. The Proposed Regulations generally provide favorable guidance with respect to modifications made to IBOR-based instruments in the context of a REMIC. Based on these Proposed Regulations, alterations to a REMIC regular interest to account for an IBOR-replacement rate or fallback rate generally are disregarded in determining whether the REMIC regular interest has fixed terms on the startup day.[3] Similarly, under Prop. Treas. Reg. § 1.860G-1(e)(3), an alteration is generally disregarded as a contingency that may otherwise disqualify such REMIC regular interest as a REMIC regular interest, and instead provides that such a contingency is a permissible contingency that would not result in a REMIC regular interest failing to qualify as such. Finally, under Prop. Treas. Reg. § 1.860G-1(e)(4), reasonable expenses paid in connection with the modification of a IBOR-linked REMIC regular interest do not (i) result

[3] Prop. Treas. Reg. § 1.860G-1(e)(2)

in an impermissible shortfall to the REMIC regular interest if such expenses are incurred by the REMIC, or (ii) result in a prohibited contribution to the REMIC if such expenses are paid by a party other than the REMIC.

II. SFA Recommendations

A. Exercise of Fallback Rate Should Not be Treated as a Significant Modification

As indicated above, the Proposed Regulations were designed to permit the replacement of or the adoption of a fallback to an IBOR-referencing rate without testing whether such alteration causes a modification of a debt instrument under previously existing law, including Treas. Reg. § 1.1001-3. However, if an existing debt instrument is modified to include such a fallback rate or a prior fallback rate is modified to provide for another fallback rate, it is not clear whether the eventual activation of that fallback rate would be entitled to automatic non-exchange treatment under Prop. Treas. Reg. § 1.1001-6, or rather, would need to be tested under the general rules of Treas. Reg. § 1001-3 (or again under the Proposed Regulations`) to determine whether such activation caused the debt instrument to be treated as modified and reissued. In other words, as drafted, the Proposed Regulations could be read to imply that two testing dates may be required for a legacy transaction, first when the fallback mechanism is added and again when the fallback mechanism operates to replace an IBOR rate in the future.

For example, consider a currently outstanding debt instrument referencing LIBOR that does not provide for a fallback. The Proposed Regulations make clear that adding a fallback rate to this instrument (rather than actually replacing LIBOR) could result in a deemed exchange that would need to be tested under the Proposed Regulations. Then, when LIBOR is ultimately replaced, as currently drafted the Proposed Regulations do not preclude the conclusion that the actual replacement of LIBOR in accordance with the previously added fallback could also result in deemed exchange that would need to be tested under the general rules of Treas. Reg. § 1.1001-3 or the Proposed Regulations, which would amount to a second testing.

In addition, in the case of the IBOR replacement recommendations of the Alternative Reference Rates Committee (the “ARRC”) for securitization transactions, a third testing could be required. These recommendations fall back first to term SOFR at the time of the IBOR replacement, but if term SOFR is not then available would fall back to compounded or simple average SOFR at such time. However, in light of the expressed preference of securitization market participants to fall back to term SOFR if available, the recommendations include an optional provision which, if included, would allow retesting after the initial replacement. In general, this retesting provision would allow an instrument that initially falls back to compounded or simple average SOFR at the

time of LIBOR replacement, to thereafter be periodically retested and to switch from compounded SOFR to term SOFR when and if such rate becomes available.[4]

Although we believe that the eventual implementation of a fallback rate, or change to a fallback rate, should be treated as associated with the initial alteration by which the qualified rate is included as a fallback rate, we request that this result be explicitly clarified. Otherwise, taxpayers will be concerned that the eventual activation of a fallback rate must be tested again under Prop. Treas. Reg. § 1.1001-6 or under the Treas. Reg. § 1001-3 and, thus, non-exchange treatment will not be assured.[5] It is clear under the Proposed Regulations that non-exchange treatment can apply to either (i) a modification that substitutes a qualifying rate for an IBOR-referencing rate or (ii) the addition of (or change to) a fallback rate.

Many tax practitioners believe that the exercise of the fallback rate can be viewed as an "associated alteration," as such a change is clearly associated with the replacement of the IBOR-referencing rate and reasonably necessary to adopt or implement that replacement rate. However, some practitioners believe that it is not clear that the triggering of the fallback rate is among the changes intended to be covered by the definition of "associated alterations." Activation of a fallback rate is not listed among the examples of associated alterations and no specific rule treats them as such. By contrast, the Proposed Regulations specifically address the triggering of a fallback rate in the context of REMICs and the OID rules.[6]

If the implementation or activation of a fallback rate is not treated as an associated alteration, it may qualify for non-exchange treatment under Prop. Treas. Reg. § 1.1001-6(a) as a transition from an IBOR rate. In that case, non-exchange treatment would depend on whether the Substantial Equivalence Requirement was met at the time the substitute rate comes into effect, which will not be knowable at the time the fallback rate is added to the debt instrument.

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[4]. *See* ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations (May 31, 2019), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization_Fallback_Language.pdf.

[5] *See* Prop. Treas. Reg. § 1.1001–6(a)(4) (any alteration to the terms of a debt instrument that is not covered by either Proposed Regulations § 1.1001–6(a)(1) or (3) is subject to the ordinary operation of Treas. Reg. § 1.1001–3).

[6] Although the term "exercise" is not explicitly used in Prop. Treas. Reg. § 1.860G-1(e)(3), both the language and the concomitant Preamble evince that the subsequent exercise of a fallback rate does not cause a REMIC regular interest to fail to qualify as a REMIC regular interest solely because the terms of the interest is subject to the contingency of a fallback rate. Similarly, the term "trigger" is not used in Prop. Treas. Reg. § 1.1275-2(m) (although it is in the accompanying Preamble), but it is clear from the operative language that the triggering of a fallback rate is not considered a change in circumstances for purposes of Treas. Reg. §1.1275-2(h)(6) and, thus, that the triggering of the fallback rate would not cause the debt instrument to be treated as if it was retired and reissued for purposes of §§ 1272 and 1273.

Alternatively, the determination of whether the change is treated as a deemed exchange could be made under the general rules of Treas. Reg. § 1.1001-3. In that case, the change might be viewed as a change that is in accordance with the terms of the instrument, in which case it would not be a modification and, accordingly, not a deemed exchange.[7] However, that may not always be the case. For example, if one party has the option to trigger the fallback rate, the exercise of that option would not be considered to be pursuant to the terms of the instrument unless it was a unilateral option.[8] But if at the time of exercise of the option by the holder (or issuer), the issuer (holder) has the right to prepay (or demand prepayment), *whether or not triggered by the exercise of the option*, the option would not be treated as a unilateral option.[9] In that case, the exercise of the option would be considered a modification, and if the modification were considered a significant modification the exercise would be treated as a deemed exchange.[10] For example, under Treas. Reg. § 1.1001-3(e)(2), the change to the new fallback rate may be a significant modification and, thus, a deemed exchange, if the annual yield on the debt instrument changes by more than 0.25%. Since the change in yield will not be known at the time the fallback rate is added to the terms of the debt instrument (or the fallback rate is modified), the triggering of the fallback rate could cause a deemed exchange of the debt instrument, which would obviate the very purpose of the Proposed Regulations.

Accordingly, we request that the final regulations clarify that the trigger or activation of a fallback rate (including any subsequent retesting of the fallback rate) that was added to the terms of a debt instrument (or non-debt instrument), or whose terms were modified, in a transaction that met the requirements of Proposed Regulations § 1.1001-6(a)(1), (2), or (3), will qualify as an *associated alteration or modification* (or alternatively, as a transition from IBOR rates (including any subsequent retesting of the fallback rate) which is deemed to meet the "substantial equivalence" test) under the Proposed Regulations.[11]

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[7] Under Treas. Reg. § 1.1001-3(c)(1)(ii), generally, the alteration in the terms of a debt instrument that occurs by operation of the terms of a debt instrument (whether automatically or at the option of the issuer or holder) is not treated as a modification of the debt instrument.

[8] *See* Treas. Reg. § 1.1001-3(c)(2)(iii) and (c)(3).

[9] *See* Treas. Reg. § 1.1001-3(c)(3)(i).

[10] *See* Treas. Reg. § 1.1001-3(b).

[11] As noted in footnote 2, above, for ease of discussion, the replacement of IBOR-referencing rates has been discussed solely in the context of debt instruments. Similar rules apply to, and similar concerns arise with, non-debt instruments. In fact, because non-debt instruments do not benefit from the unilateral option exception of Treas. Reg. § 1.1001-3(c)(2)(iii) and (c)(3), the concern is amplified with non-debt instruments.

B. The Proposed Substantial Equivalence Requirement

We understand that the intention of Treasury and the IRS for the Proposed Regulations was to "broadly facilitate the transition away from IBORs," while ensuring the regulations are "no broader than is necessary to replace the IBOR in the terms of a debt instrument or non-debt contract with a new reference rate."[12] We believe the Proposed Regulations are broad when it comes to the rate portion of the "qualified rate" definition in Prop. Treas. Reg. § 1.1001-6(b)(1) but that the Substantial Equivalence Requirement in Prop. Treas. Reg. § 1.1001-6(b)(2) needs clarification and expansion.

Below, we separate our concerns and recommendations into the three currently proposed options under the Substantial Equivalence Requirement: (a) the Historical Average Safe Harbor, (b) the Arm's Length Safe Harbor, and (c) the Substantial Equivalence Requirement without a safe harbor.

i. Historical Average Safe Harbor

We have two concerns with the Historical Average Safe Harbor.

Our first concern is that the Proposed Regulations are not clear on how to apply the Historical Average Safe Harbor in a situation in which an instrument is modified to include a fallback mechanism for its IBOR rate where that mechanism includes multiple rates as fallback options. Most fallback mechanisms will include multiple rates as options. For example, the ARRC recommendations for securitization transactions include a fallback waterfall with five different rates as fallbacks. If the transaction documents for a legacy transaction currently using LIBOR is modified to include the ARRC recommended fallback waterfall to LIBOR, to which rate should LIBOR be compared under the Historical Average Safe Harbor? We do not believe Treasury and the IRS intended the Historical Average Safe Harbor to be applied to all of the rates in the waterfall. Additionally, it is unclear how the Historic Average Safe Harbor should apply if one or more of the rates in the waterfall do not currently exist (e.g., the first fallback rate in the ARRC recommended waterfall is Term SOFR plus an adjustment, and this rate does not currently exist). Moreover, the spread adjustment, which is added to all fallback rates in the waterfall, has not yet been recommended or selected by the ARRC.

We recommend that the final regulations provide which rate in a fallback waterfall should be compared with LIBOR under the Historical Average Safe Harbor. In this regard, we recommend that the comparison be made using the most likely fallback rate at the time the fallback mechanism is added. This can easily be identified, because the fallbacks are structured such that

[12] Preamble, p. 54072.

the replacement rate is the rate in the first step in the order of the waterfall under which a rate can be determined based on information then available.

Our second concern is that it may be unclear at the time a fallback mechanism is adopted or modified whether at the time of the actual replacement of an IBOR rate (presumably at the end of 2021), a replacement rate will satisfy the Historical Average Safe Harbor. For example, while SOFR (which looks at a single overnight rate) has historically been close to overnight LIBOR, the rate has had some volatility in the recent past.[13] Thus, there is a risk that market participants may not have absolute certainty that they may rely on this safe harbor in structuring their IBOR rate fallback mechanics today. Therefore—consistent with our recommendation that the exercise of a fallback rate should not trigger a significant modification when the fallback provision was added to the terms of an instrument in a transaction that met the requirements of Proposed Regulations § 1.1001-6(a)(1), (2), or (3)—we recommend that the final regulations state that where the Historical Average Safe Harbor is met on the date a fallback mechanic is adopted (including an inclusion in the terms of an instrument at issuance), the Historical Average Safe Harbor is deemed to be met on the date that the fallback mechanic operates to replace an IBOR rate.

ii. Arm's Length Safe Harbor

We believe there are four areas in which the Arm's Length Safe Harbor can be improved to consistently apply Treasury's and the IRS's goal to broadly facilitate the transition away from IBORs while ensuring that the regulations are no broader than is necessary to replace the IBOR in the terms of a debt instrument or non-debt contract with a new reference rate.

1. Allow Overlap with Treas. Reg. § 1.1001-3

Many transactions in the securitization and structured finance market have adopted or will adopt the ARRC recommended fallback waterfall, or another fallback waterfall, so when the time comes to ultimately replace an IBOR rate, a clear mechanism is in place. Before the issuance of the Proposed Regulations, some transactions were intentionally structured so that when an IBOR rate was replaced, the replacement would fall within the safe harbor of Treas. Reg. 1.1001-3(c)(ii) relating to "unilateral options." Under that regulation, an alteration of a legal right or obligation that occurs by operation of the terms of the debt instrument is not a modification.[14]

[13] For example, in September 2019, SOFR was three percentage points higher than LIBOR for a day. *See* Daniel Kruger and Vipal Monga, "Repo-Market Tumult Raises Concerns About New Benchmark Rate," The Wall Street Journal (September 23, 2019), available at https://www.wsj.com/articles/repo-market-tumult-raises-concerns-about-new-benchmark-rate-11569247352/.

[14] Treas. Reg. § 1.1001-3(c)(1)(ii).

Such an alteration may occur automatically or may occur as the result of an option provided to the issuer or holder to change the terms of a debt instrument.[15] An alteration that results from the exercise of an issuer or holder option to change a term of a debt instrument only fits within this regulation if (a) the option is unilateral and (b) for a holder option only, the exercise does not result in a deferral of, or reduction in, any scheduled payment of principal or interest. An option is unilateral only if, under the debt's terms or applicable law (i) there does not exist, at the time of exercise or as a result of exercise, a right in the other party to alter or terminate the debt instrument or to put the instrument to a related person to the issuer, (ii) the exercise of the option does not require the consent of the other party, a related party or a court, and (iii) the exercise of the option does not require consideration unless on the debt instrument's issue date the consideration is a de minimis amount, a specified amount, or an amount based on a formula that uses objective financial information.[16]

The Arm's Length Safe Harbor requires the parties to determine, based on bona fide, arm's length negotiations between the parties, that the fair market value of the debt instrument before the alteration is substantially equivalent to the fair market value of debt instrument after the alteration. If the parties to a debt instrument must negotiate the replacement of an IBOR rate, even in the case of an instrument that includes a fallback waterfall, arguably the fallback waterfall can never be viewed as an option that does not require the consent of the other party within the meaning of Treas. Reg. § 1.1001-3(c). Furthermore, in a securitization, a transaction party may propose an amendment to convert from an IBOR to a replacement rate, which amendment is only effective upon the consent of the investors. If the investors provide the requisite consent, the amendment should qualify for the Arm's Length Safe Harbor .

Thus, we believe that the final regulations under Treas. Reg. § 1.1001-6 should make clear that they supplement rather than supplant existing rules under Treas. Reg. § 1.1001-3, by providing that any right of a party to determine and agree to the fair market value of an instrument pursuant to the Arm's Length Safe Harbor (including the exercise of an investor consent right) will not constitute a consent right under Treas. Reg. 1.1001-3(c).

2. *Clarification on Who is a "Party" for Purposes of the Arm's Length Safe Harbor*

The Proposed Regulations are not clear on who constitutes a "party" that can determine fair market value for purposes of the Arm's Length Safe Harbor. In many transactions, if not most, it is common for debtholders or an issuer to have a representative serve in connection with the holding or issuance, respectively, of the debt. In addition, in some cases one of the parties to a debt instrument might no longer exist. In many legacy securitizations it is possible that both the

[15] *Id.*

[16] Treas. Reg. § 1.1001-3(c)(3).

issuer and the underwriter are no longer in business. While we assume Treasury and the IRS intended that an appointed representative can agree on behalf of a debtholder (e.g., a trustee) or the issuer (e.g., an asset manager), an appointed representative may be reluctant to agree to perform this function without clear guidance that such representation is permitted under the Arm's Length Safe Harbor.

We recommend that the final regulations provide a broad definition of "party" for this purpose, specifically permitting an issuer's or debtholder's appointed (or implied) representative or designee to constitute a "party," also including as a "party" any successor to such a representative or designee.

3. Upfront Agreement

Parties generally would determine the rates contained in a fallback waterfall for replacing an IBOR so as not to alter the fair market value of an instrument when the fallback mechanism is selected and included in the terms of the instrument. We believe this could be tested as of the introduction of the fallback waterfall and still accomplish Treasury's and the IRS's intent to prevent Treas. Reg. § 1.1001-6 from allowing changes beyond replacing a reference rate, since the fallback mechanics themselves will already undergo arm's length scrutiny when entered into and the requirement of a testing upon the future date when a fallback is implemented would make the Arm's Length Safe Harbor difficult (if not impossible) to rely upon as a useful safe harbor.

We recommend that the final regulations make clear that no testing upon the change to a fallback rate is required where the parties agree that a future replacement is not intended to alter the fair market value of an instrument, so long as the replacement does not make changes other than those necessary to enable the replacement. We believe market participants would be willing to memorialize their upfront arm's length negotiations in deal documentation.

4. Allow Determinations Based on Yield

Investors may prefer instruments with LIBOR fallbacks, particularly in cases where ARRC specifically recommends fallbacks. This leads to increased liquidity for debt instruments that include a fallback, which may increase the fair market value of those debt instruments (i.e., the addition of a fallback itself can potentially increase the value of an instrument, irrespective of whether the fallback rate is substantially equivalent to the IBOR rate it replaces). While this potential increase in value may dissipate as more instruments adopt fallbacks for IBOR rates, it still presents an issue with reliance upon the Arm's Length Safe Harbor currently and during the near term.

The Historical Average Safe Harbor is focused on the yield of an IBOR-based rate and a replacement rate, and the Arm's Length Safe Harbor should also allow for parties to qualify under that safe harbor, based on bona fide arm's length negotiations that determine that the instrument has an IBOR-based rate and a replacement rate that produce a substantially equivalent yield. This would mitigate the fair market value concern from increased liquidity discussed above.

Accordingly, we recommend that the Arm's Length Safe Harbor be expanded to allow parties to rely upon it, provided that before and after the alteration replacing the IBOR-based rate or adding a fallback mechanism for an IBOR-based rate, either (a) the fair market value of the instrument is substantially equivalent, or (b) the yield on the instrument is substantially equivalent.

iii. Situations with No Safe Harbor

If both the Historical Average Safe Harbor and the Arm's Length Safe Harbor are unavailable, the Proposed Regulations contemplate that parties may rely on the general Substantial Equivalence Requirement in Prop. Treas. Reg. § 1.1001-6(b)(2)(i). We believe that a third safe harbor is appropriate and consistent with Treasury's and the IRS"s intent for the Proposed Regulations. In addition, we seek additional clarification on what fair market value means where the Substantial Equivalence Requirement (and no safe harbor) may apply.

1. *Third Safe Harbor and Further Relief for Instruments Using ARRC Recommended Fallbacks or Revised ISDA Definitions*

Investors in securitizations and structured finance transactions require certainty. One reason the ARRC recommended fallbacks are becoming more common in the market is so that investors can have certainty and know what to expect. Given that, we recommend that the Proposed Regulations recognize the broad and increasing reliance on ARRC (and ISDA) replacement and fallback rates.

Under the Proposed Regulations, any alternative, substitute or successor rate selected, endorsed or recommended by the central bank, reserve bank, monetary authority or similar institution (including any committee or working group thereof) is specifically permitted as a "qualified rates."[17] We recommend, firstly, that this clause be revised to specifically reference rates determined by the ARRC, as well as ISDA.

[17] Prop. Treas. Reg. § 1.1001-6(b)(1)(ix).

In addition, the Historical Average Safe Harbor specifically permits the historical average to be determined by using any method "recommended by the International Swaps and Derivatives Association" ("ISDA") or "recommended by the ARRC."[18] Yet there is no specific safe harbor in the Proposed Regulations treating the use of ARRC recommended benchmark rates, or the to-be-published revised ISDA definitions containing LIBOR fallback language and the related rates, generally as qualified rates that do not result in a deemed exchange.

Both ISDA and ARRC contemplate that a benchmark used to replace a term IBOR would not be the overnight benchmark itself. Rather, in the US, the replacement benchmark could be term SOFR (a forward looking benchmark derived from future values of SOFR observed in futures or derivatives trading), or compounded or simple averaged values of SOFR (in advance or in arrears) as published over an observation period. ISDA has endorsed a compounded in arrears approach. The ARRC securitization fallbacks allow compounded or simple averages in advance or in arrears.

Both ARRC and ISDA recognize that having identified a replacement benchmark (such as SOFR compounded in arrears), it is further necessary to add a spread adjustment in order to ensure there is minimum value transfer. ISDA has endorsed the use of historic data for both the IBOR being replaced and the new benchmark to determine a value neutral spread adjustment. The ARRC fallbacks contemplate, as the first step in the spread adjustment waterfall, the use of a "spread adjustment, or method for calculating or determining such spread adjustment, (which may be a positive or negative value or zero) that has been selected, endorsed or recommended by the Relevant Governmental Body" (which includes ARRC.)

The Proposed Regulations would permit taxpayers to determine the historical averages using a methodology recommended by either ISDA or ARRC.

But ISDA is doing more than just providing a methodology for spread adjustments. ISDA has announced that it has selected a vendor to calculate and publish spread adjustments for use with the revised ISDA definitions.[19] Similarly, it is possible that ARRC may publish or endorse actual spread adjustments, not just a methodology.

We recommend that the final regulations include a third safe harbor, under which the use of a spread adjustment published, selected, endorsed or recommended by either ARRC or ISDA for the replacement of an IBOR with a qualifying rate, shall be deemed to satisfy the Substantial Equivalence Requirement.

[18] Prop. Treas. Reg. § 1.1001-6(b)(2)(ii)(A).

[19] https://www.isda.org/2019/07/31/bloomberg-selected-as-fallback-adjustment-vendor/.

2. Further Clarification on the Definition of Fair Market Value

The Proposed Regulations might better clarify what measurements can be used and relied on for determining fair market value. The Proposed Regulations state that in determining fair market value, the parties may use any reasonable, consistently applied valuation method that may (but need not) be based in whole or in part on past or projected values of the relevant rate. Treas. Reg. § 1.1273-2(f) identifies various circumstances in which debt instruments are considered to be acceptably valued, such as circumstances involving the existence of a sales price, firm quotes from at least one broker, dealer, or pricing service, and indicative quotes from at least one broker, deal, or pricing service.[20] These rules also provide that the fair market value of property is presumed to be equal to its sales price or quoted price.[21]

We recommend that the final regulations reference the rules of Treas. Reg. § 1.1273-2(f) for purposes of satisfying the Substantial Equivalence Requirement. In particular, the final regulations should specifically permit hypothetical quotes on instruments after a reference rate change to be used for this purpose.

C. Clarification of the Application of the Substantial Equivalence Requirement to One-Time Payments

As noted above, Prop. Treas. Reg. § 1.1001-6(b)(2) provides that a rate is a qualified rate only if it satisfies the Substantial Equivalence Requirement. The parties may use any reasonable, consistently applied valuation method and must take into account the value of any one-time payment made in connection with the alteration or modification. Neither the effect of a one-time payment on the calculation of fair market value nor how such payment is meant to be taken into account for purposes of making the fair market value determination is completely clear.

For example, assume that a US$50 million LIBOR based debt instrument with a spread over LIBOR of 1.00% is modified into a US$50 million SOFR based debt instrument with a spread over SOFR of 1.00%. The holder and the debtor are unrelated. A substantial payment (e.g., a payment equal to 10% of the face of the new debt instrument) is made by the issuer to the holder to induce the holder to accept the new rate. This payment did not reduce the face amount of the instrument. The two parties agree that the fair market value of the modified instrument differs from the existing instrument by the amount of the payment being made. Does the upfront payment being made to induce a party to accept the rate on the new instrument make the existing instrument and modified instrument "substantially equivalent" value because the modified instrument plus the amount of cash being transferred (by the issuer

[20] Treas. Reg. § 1.1273-2(f)(1).

[21] Treas. Reg. § 1.1273-2(f)(5).

to the holder in the foregoing example) is equal in value to the existing instrument? If this is the case, under what circumstances would the fair market value standard not be satisfied between an unrelated holder and issuer? It would be helpful to provide an example that illustrates that the size of the payment does not matter and an example that indicates when this standard would not be satisfied between unrelated parties.

In the alternative, does a substantial payment mean that the existing and modified instruments are not of substantially equivalent fair market value? If the payment is taken into account in this manner (demonstrating the difference in fair market value between the existing instrument and the modified instrument), then how much of a payment is considered insubstantial—i.e., does not prevent the modified instrument from having a fair market value that is "substantially equivalent" to the existing instrument. If this was the intent, we recommend that a payment equal to the transaction costs of modifying the instrument plus an inducement amount of a small amount (e.g., 1% or less of the face amount of the instrument) would not prevent an existing instrument from having a fair market value that is substantially equivalent to the modified instrument.

D. Character and Source of One-Time Payments

As discussed in Part I, under Prop. Treas. Reg. § 1.1001-6(d), the source and character of any such one-time payment is “the same as the source and character that would otherwise apply to a payment made by the payor with respect to the debt instrument.” While we believe this rule generally would have the effect of exempting one-time payments by U.S. issuers from U.S. federal withholding tax, it would be helpful if the final regulations explicitly clarified this intent. Moreover, it is not entirely clear from the proposed regulations how the parties should account for the issuer’s one-time payment, and we would appreciate it if the final regulations addressed this question. Under one possible approach, the payment would be treated, first, as a payment of accrued interest (to the extent of any accrued and unpaid interest at the time of the payment) and, second, as a return of principal.[22] This approach would reduce the debt instrument’s adjusted issue price to the extent that the payment exceeds accrued and unpaid interest on the debt instrument.[23] The reduction would give rise to additional capital gain or capital loss to the holder upon a subsequent sale or disposition of the debt instrument, and a deduction to the issuer upon a subsequent retirement or redemption of the debt instrument.[24] However, if a

[22] *Cf.* Treas. Reg. § 1.446-2(e)(1) (treating payments as interest to the extent of accrued and unpaid interest); regs. § 1.1275-2(a) (payment ordering rules). This approach is consistent with the approach adopted in PLR 201105016. There, the IRS ruled that a consent fee paid in consideration for a modification of a debt instrument was treated as a payment under the debt instrument, and not as a separate fee item, and thus governed by Treas. Regs. § 1.446-2(e)(1) and 1.1275-2(a).

[23] Treas. Reg. § 1.1275-1(b)(1)(ii).

[24] Treas. Reg. § 1.163-7(c).

portion of the one-time payment is characterized as accrued interest, it is unclear whether a subsequent payment of that accrued interest would be treated as a return of principal or as interest.[25]

Under an alternative approach, the one-time payment would be accounted for as original issue discount over the remaining term of the debt instrument (assuming that the payment is not *de minimis*).[26] This alternative approach arguably makes sense as a policy matter, because the one-time payment represents an interest rate adjustment that relates to the remaining term of the debt instrument. However, it could create administrative burdens for securitization vehicles that did not expect to report original issue discount when they were formed.[27]

E. REMIC Qualification

As discussed in Part I, the Proposed Regulations provide helpful guidance on IBOR replacement and REMIC qualification.

We would recommend that additional guidance be issued with respect to the modification of IBOR-based underlying mortgage loans held by a REMIC. A REMIC may hold thousands of underlying mortgage loans, each of which may be serviced by a third-party servicer who, in turn, must interface with each individual issuer regarding a modification of their IBOR-based mortgage loan. The modification of an underlying mortgage loan that does not satisfy the Substantial Equivalence Test may cause such "new" mortgage loan to not be treated as a "qualified

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[25] Treating the subsequent payment as a return of principal would be economically akin to treating the entire one-time payment as a payment of principal. Treating the subsequent payment as interest would cause different tax results to the parties depending on the amount of accrued interest on the debt instrument at the time of the modification.

[26] *Cf.* Treas. Reg. § 1.1275-2(j) (if a debt instrument is modified in a manner that does not cause a taxable exchange but that defers one or more payments, then the debt instrument is treated as retired and reissued for purposes of calculating original issue discount).

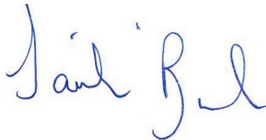
[27] If the IRS adopts this alternative, then it may be appropriate under certain circumstances to allow issuers to elect to report the one-time payment as a current payment of interest to minimize the administrative burden of accounting for the one-time payment as original issue discount. *Cf.* Regs. § 1.1275-4(b)(6) (treating an unscheduled payment on a contingent payment debt instrument as a positive adjustment that is currently deductible to the issuer and currently taxable to the holder). However, this election could create some potential for abuse. For example, if the issuer is a pass-through entity owned primarily by U.S. taxpayers and has issued debt primarily to non-U.S. persons, then there might be an incentive for the issuer to choose a qualified rate whose value is significantly lower than the IBOR-based rate, and to make a large one-time payment to offset this difference in value. Regulations might limit this potential for abuse by making the election available only if the amount of the one-time payment does not exceed some threshold (*e.g.*, 2-5% of the debt instrument's adjusted issue price at the time of the modification). We would welcome the opportunity to provide further comments on this matter if the IRS decides to adopt this alternative.

mortgage" under Section 860G(a)(3) of the Code which, in turn, may cause the REMIC to fail to qualify as a REMIC.[28] Given that the servicer may be required to undertake modifications of thousands of mortgage loans with respect to a single REMIC, it may be difficult to confirm whether each such modification meets the Substantial Equivalence Requirement. Because REMIC servicing agreements generally prohibit the servicer from modifying a mortgage loan in a REMIC if such modification would result in a significant modification under Treas. Reg. § 1.860G-2(b)(1), a servicer may not have sufficient certainty that each of the potentially thousands of modifications of mortgage loans that it is expected to undertake satisfy the Substantial Equivalent Test. As such, this lack of certainty may cause significant delays or even failures to effect the modifications needed for an orderly transition from an IBOR-based rate.

In the context of a REMIC, current Treasury regulations provide certain enumerated exceptions (including if the modification is occasioned by default or a reasonably foreseeable default) from "significant modification" treatment for modifications that would otherwise be treated as a "significant modification" under Section 1001 of the Code.[29] Based on the foregoing, we would recommend an additional exception be issued under Treas. Reg. § 1.860G-2(b)(3) to the effect that any modification of an IBOR-based underlying mortgage loan held by a REMIC to account for an IBOR-replacement rate or fallback rate, irrespective of whether such modification meets the Substantial Equivalence Test, shall not result in a "significant modification" of such underlying mortgage loan. By issuing the guidance under this provision, it would provide clarity and would prevent (i) a loan that was a "qualified mortgage" at the time of contribution from no longer being considered a "qualified mortgage", (ii) such modification from resulting in a prohibited transactions tax under Section 860F(a)(2) of the Code, and (iii) such modification from resulting in a prohibited contributions tax under Section 860G(d) of the Code.

Thank you for providing the opportunity to provide comments on REG-118784-18. If you have any questions, please do not hesitate to contact Sairah Burki at (202) 524-6302.

Respectfully submitted,



Sairah Burki
Head of Policy
Structured Finance Association

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[28] Such a failure may cause the REMIC to be reclassified as a taxable mortgage pool (under Section 7701(i) of the Code) taxable as a corporation, and holders of debt issued by the REMIC may be treated as shareholders in a corporation for income tax purposes.
[29] Treas. Reg. § 1.860G-2(b)(3).