

Board of Directors

Chair
Debra A. Cafaro
Chairman and CEO
Ventas, Inc.

President and CEO
Jeffrey D. DeBoer

Treasurer
Thomas M. Flexner
Vice Chairman and Global Head
of Real Estate
Citigroup

Secretary
Tim Byrne
President and CEO
Lincoln Property Company

Dr. Thomas R. Arnold
Global Head of Real Estate
Abu Dhabi Investment Authority

Thomas J. Baltimore, Jr.
Chairman, President and CEO
Park Hotels & Resorts
Immediate Past Chair, Nareit

Tray E. Bates, CCIM SIOR CIPS
Principal
Bates Commercial LLC
*Former Commercial Committee Chair
National Association of Realtors®*

Jeff T. Blau
CEO
Related Companies

Richard B. Clark
Managing Partner & Chairman
Brookfield Property Group

John F. Fish
Chairman and CEO
SUFFOLK

Steven Hason
Managing Director, Head of Americas Real
Estate and Infrastructure
APG Asset Management US Inc.
*Immediate Past Chairman, Pension Real Estate
Association*

Anthony E. Malkin
Chairman and CEO
Empire State Realty Trust, Inc.

Roy Hilton March
Chief Executive Officer
Eastdil Secured

Kathleen McCarthy
Global Co-Head of Blackstone Real Estate
Blackstone

Jodie W. McLean
Chief Executive Officer
EDENS

Robert R. Merck
Senior Managing Director and
Global Head of Real Estate Investments
MetLife

Holly Neber
CEO
AEI Consultants
2019 President, CREW Network

David Neithercut
Former President and Chief Executive Officer
Equity Residential

Ross Perot, Jr.
Chairman
Hillwood

William C. Rudin
Co-Chairman and CEO
Rudin Management Company, Inc.
*Immediate Past Chair
The Real Estate Roundtable*

Rob Speyer
President and CEO
Tishman Speyer

Barry Sternlicht
Chairman and CEO
Starwood Capital Group

Owen D. Thomas
Chief Executive Officer
Boston Properties



The Real Estate Roundtable

June 6, 2019

The Honorable David J. Kautter
Assistant Secretary of Tax Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Assistant Secretary Kautter and Chief Counsel Desmond:

Recent commercial and regulatory developments affecting the use of LIBOR – the London Interbank Offered Rate – raise important tax issues that Treasury and the Internal Revenue Service should address. The Real Estate Roundtable respectfully recommends that Treasury or the IRS clarify the circumstances in which replacing references to LIBOR in an existing debt instrument or other financial instrument with references to another index or formula may occur without causing the instrument to be treated as “modified” or “exchanged” for tax purposes. Appropriate and well-designed guidance addressing these situations will help avoid serious disruptions in the financial markets, the real estate industry, and the overall economy.

Arguably, in any given case, a bona fide agreement to replace a defective or obsolete reference in an existing agreement would not be a modification at all. However, because tax uncertainty could interfere with the orderly renegotiation of trillions of dollars’ worth of financial instruments, we believe that a safe-harbor rule is appropriate. Specifically, we recommend that the Treasury or IRS clarify that the voluntary replacement of references to LIBOR, in an existing debt or other financial instrument, with a replacement index or formula that has either been identified by regulators, broad industry groups or similar objective sources as a fair and suitable replacement for LIBOR, or that has been selected by the parties in good faith with the principal purpose and effect of preserving their original commercial agreement at the time the instrument was originated, is not considered an alteration or modification of the original instrument. Instead, the replacement should be treated for Federal tax purposes as a continuation of the instrument’s original terms.

EXECUTIVE SUMMARY

- Trillions of dollars of existing floating rate (adjustable and variable) loans and other financial instruments use LIBOR to set their interest rates.
- Because LIBOR is based on the “expert judgment” or “market-based observations” of panel banks, without basis in actual inter-bank transactions, it is being phased out by national regulators globally as it continues to be susceptible to manipulation. In the meantime, LIBOR quotes that are still available may become increasingly unreliable. Thus, LIBOR will need to be replaced in innumerable existing legacy agreements, not just in new agreements.

- The anticipated replacement of LIBOR in existing financial instruments poses a potential tax problem: avoiding a deemed taxable “exchange” of the instrument if the replacement index is viewed as “significantly modifying” the interest rate or yield of the existing instrument. There are several aspects to this tax problem that we believe warrant guidance.
- First, some changes to existing agreements will occur after bank regulators, government officials, broad industry groups, or other objective sources clearly indicate that one or more particular replacement indices constitute an appropriate substitute for LIBOR. In such cases, the voluntary adoption of the substitute index (or a formula such as Prime+1) by the parties to an existing instrument should not be considered an alteration of the parties’ original agreement, in the same way that modifying a currency-based term to deal with a governmentally imposed replacement of one national or multi-national currency with another currency is not typically treated as a deemed exchange of the affected financial instrument. See, e.g., Treas. Reg. § 1.1001-5(a) (substitution of EURO for EU national currencies not a deemed exchange).
- Second, in other cases the parties may seek to replace LIBOR with an index or formula other than one on which there is a definitive indication from regulators or other objective sources that the desired replacement index is economically equivalent to the parties’ original agreement to use LIBOR. This may occur because—now that the “clock is ticking” on the eventual elimination of LIBOR quotes—the parties wish to get the issue of replacing LIBOR behind them, even before there is broad agreement on an acceptable substitute.
- Third, a replacement may occur because, for various reasons, the parties to a particular agreement may not find any broadly approved substitutes to be acceptable. For example, one nation’s regulator, or a group of housing industry market participants in that nation, may adopt a suggested replacement, which would qualify as an objective replacement, but it may not be acceptable to some lenders or borrowers from another country or industry.

In both the second and third cases, the replacement should not be considered a significant modification as long as it is occurring in good faith with the principal purpose and effect of replacing LIBOR with an index or formula selected to preserve the parties’ original commercial agreement at the time the loan was originated. The replacement of LIBOR in such cases should not give rise to a deemed exchange of the existing instrument under the provisions of Treas. Reg. § 1.1001-3, or any similar provision of the tax law related to modifications of existing financial instruments. To illustrate the proposed rule, it would not be acceptable for a replacement index to be designed or selected to compensate the lender for a post-origination deterioration in the borrower’s credit quality, or to discourage the borrower from prepaying a loan to take advantage of a decline in market interest rates.

- Fourth, in any of these cases, the replacement index should be allowable even if the existing agreement already provides for a contractual substitute in the event that LIBOR quotes are temporarily (or even permanently) unavailable, and even if such a substitution has already occurred.¹ Such legacy contractual terms were likely developed when the unavailability of LIBOR was considered a highly remote contingency. Now that the potential unavailability or unreliability of LIBOR quotes is imminent it may become clear to the parties that the original contractual “fall-back” for LIBOR (*e.g.* Prime Rate) does not fairly reflect the parties original economic arrangement and should be replaced with a more suitable substitute index.

¹ For example, the prime rate hardwired into many cash financial contracts as a fallback rate would not be economically equivalent to LIBOR as it has been, on average, approximately 275 basis points higher than LIBOR over the last 35 years.

- Fifth, any replacement of a replacement of LIBOR (etc.) should be subject to these rules.
- Sixth, similar rules should ideally apply generically to all tax issues where the replacement of an index could be considered to be a modification or alteration of the original agreement. While the IRS and Treasury could compile a specific list (including such items as the REMIC “fixed terms” rule, the OID rules, various “grandfather” rules for existing instruments) it may be better to provide a generic rule that index replacements coming within these guidelines will be disregarded and treated as a continuation of the replaced terms for all tax purposes.

DETAILED ANALYSIS

The Financial Background of the Problem

LIBOR underpins hundreds of trillions of dollars in contracts around the world, from residential and commercial mortgage loans, to complex derivatives, to credit cards and auto loans. There are more than \$200 trillion of USD LIBOR contracts outstanding. Roughly \$1.3 trillion of commercial real estate debt is indexed to LIBOR, as are most floating rate residential mortgage loans.

In 2012, the newly-created UK Financial Conduct Authority (FCA) was given regulatory oversight of LIBOR.² In 2014, the Financial Stability Board (FSB) published a report³ recommending the transition away from LIBOR to new reference rates supported by actual market transactions as opposed to bankers’ judgments. Thereafter, regulatory bodies and governmental agencies around the world began in earnest to identify new reference rates. The growing scarcity of actual inter-bank unsecured term money market funding since 2008—and the growing reluctance of the LIBOR panel banks (because of potential liability and reputational concerns) to offer “expert judgment” or “market-based observations” without a basis in actual inter-bank transactions⁴—led the FCA to publicly acknowledge that “the survival of LIBOR on the current basis . . . could not and would not be guaranteed” after December 31, 2011 (“Cessation”).⁵ On July 27, 2017, Andrew Bailey, Chief Executive of the FCA, announced that the FCA would no longer compel banks to submit quotes for LIBOR after 2021, leaving less than three years to prepare for transition to a new benchmark rate.

In response to these developments, global policymakers concluded that LIBOR must be replaced with an alternative benchmark rate based firmly on actual, verifiable trading transaction data from relevant market participants in a “sufficiently active” market of substantial volume if it is to be less susceptible to manipulation.

² The British Bankers Association oversaw LIBOR until the 2012 “rigging” scandal when it was forced to give up its responsibility for setting the rate.

³ Financial Stability Board, [Reforming Major Interest Rate Benchmarks](#) (July 22, 2014).

⁴ 3-month LIBOR, the most heavily referenced LIBOR tenor, has shrunk to a median trading volume of less than \$1 billion daily and less than \$100 million on some days; while 1-month LIBOR the most frequently used tenor for mortgage loans (commercial as well as residential) is not more actively traded. Jerome H. Powell, future Chairman of the Federal Reserve Board of Governors, [Remarks at the Roundtable of the Alternative Reference Rates Committee](#), New York, NY at 2 (Nov. 2, 2017).

⁵ Andrew Bailey, [The Future of LIBOR](#), Address by Chief Executive of FCA at Bloomberg London (July 27, 2017).

In late 2014, the Board of Governors of the Federal Reserve System and Federal Reserve Bank of New York formed the Alternative Reference Rates Committee (ARRC), which is comprised of market participants⁶, industry associations, and government agencies. ARRC is charged with: (a) identifying a replacement rate for USD LIBOR consistent with existing “Principles for Financial Benchmarks” of the International Organization of Securities Commissions (IOSCO), regarding the rate’s construction, governance and accountability; (b) addressing legacy contract triggers and benchmark fallbacks; and (c) planning the transition for cash products as well as derivatives away from LIBOR. In June 2017, ARRC selected the Secured Overnight Financing Rate (SOFR) as its preferred replacement rate⁷, which differs from LIBOR in many respects—most notably it is a secured, risk-free, overnight rate, rather than a forward term structure with a bank credit risk component. While ARRC contemplates a forward-looking term SOFR structure by the end of 2021, the lack of a term structure before that date should not be an impediment to parties commencing use of SOFR as a benchmark before Cessation. The Federal Reserve has provided an excellent and practical “how-to” guide to encourage users to begin to adopt SOFR as a benchmark in new transactions, in fallbacks, as well as amendments to legacy fallbacks, without having to wait for sufficient liquidity to develop in the markets to allow determination of a term SOFR rate.

In March 2018, ARRC was reconstituted to develop strategies to facilitate the transition from LIBOR across cash products: floating rate notes, bilateral business loans, syndicated business loans, securitizations, and consumer products. The ARRC working groups consists of market participants and advisors and industry associations across the related markets.⁸ The ARRC working groups’ goal is to minimize the disruption to the markets caused by the transition away from LIBOR.

In legacy contracts when LIBOR publication is temporarily interrupted or unavailable, there exists no uniform trigger to a fallback alternative rate in the market, which may vary as often within a lender’s organization as they do among different lenders. Extant agreements often, but not always, provide for a short-term alternative mechanism for determining the unsecured inter-bank lending rate either directly from the usual LIBOR quoting banks or specifically designated ‘reference’ banks, but if such determination is not possible in a market disruption (or if such banks simply decline to respond), most agreements then default to using the prime or base rate, or the effective Federal Funds rate (outside of the United States, the lender’s cost of funds). It was never contemplated in these LIBOR agreements or derivatives products that a permanent replacement to published LIBOR would be necessary; and being standard boilerplate, the “temporary” fallback provision for such a highly unlikely event was rarely the subject of any serious consideration or negotiation. Few, if any, outstanding contracts include language detailing the steps taken to replace LIBOR if it is no longer available or deemed to be defective or unreliable.

Following the completion of its public consultations on contractual fallback language proposed by its various cash product working groups, the ARRC has now recommended more robust fallback language for floating rate notes, syndicated loans, bilateral business loans, and securitizations for

⁶ The market participants include financial exchanges, banks, asset managers, insurers, and other end users, as well as government sponsored entities.

⁷ SOFR is “produced by the Federal Reserve Bank of New York for the public good”, “is derived from an active and well-defined market” and “is based on observable transactions”. AARC, [A User’s Guide to SOFR](#), at 2 (April 2019).

⁸ The member participants and advisors include asset managers, and insurers, banks and financial service firms, financial infrastructure and consulting firms.

voluntary adoption by marketplace participants.⁹ Although the Federal Reserve's expectation is that market participants will choose whether and when to: begin using the recommended fallback language in their new floating rate transactions, amend their legacy transactions, or commence the use of SOFR, as they deem appropriate, it seems that market participants "are dawdling in their adoption of the Federal Reserve's preferred replacement for [LIBOR]."¹⁰

Several factors may be contributing to the reluctance of market participants to use SOFR, including: (1) lack of the necessary internal infrastructure to support accounting and trading of SOFR; (2) the operational inability of internal existing systems to generate a three factor interest rate which will be necessary to create a SOFR that is the economic equivalent of LIBOR (as a secured rate the counterparty credit risk differential of LIBOR needs to be added); (3) the continuing uncertainty of how, who and when the credit risk differential will be determined; (4) questions regarding the tax consequences of the replacement of LIBOR with a new benchmark for the parties; and (5) the litigation risks involved in contentious modifications, especially if the EU or ICE continues to publish an IBOR-like rate after Cessation.

After ARRC's recent release of two publications—a white paper to encourage market participants to use SOFR in their issuance of new cash products or amendment of existing, legacy cash products¹¹ and a newsletter describing the growth in SOFR's liquidity and the progress in the transition away from LIBOR in the past 12 months¹²—Randal Quarles, the Federal Reserve vice chairman in charge of financial regulation reiterated this week the urgency of moving forward:

I believe that the ARRC has chosen the most viable path forward and that most will benefit from following it, but regardless of how you choose to transition, beginning that transition now would be consistent with prudent risk management and the duty that you owe to your shareholders and clients. . . . With only two and a half years of further guaranteed stability for LIBOR, the transition should begin happening in earnest.¹³

⁹ As an alternative to LIBOR, ARRC's contractual fallback language contains: benchmark triggers (events that would initiate a transition away from LIBOR to a successor rate) and a benchmark replacement rate (a waterfall of specific successor rates in order of decreasing priority), together with a spread adjustment to make it more comparable to LIBOR. Given the enormous complexity and cost as well as potential market disruption inherent in the current LIBOR/SOFR transition process, the perceived inadequacy of the current rate modification rule, and the desire to avoid this exercise in the future, ARRC went to great pains to create a waterfall of replacement benchmarks that could be hardwired in the transaction documents in the event that any replacement rate becomes unavailable, permanently or temporarily, for any reason whatsoever. For example, if term SOFR is unavailable on Cessation of LIBOR, the next replacement rate could be used, and upon the commencement of a term SOFR rate, the transaction could revert to that rate without causing a sale/exchange under the Code.

¹⁰ Daniel Kruger & Telis Demos, [Firms Slow to Adapt LIBOR Replacement](#), WALL STREET JOURNAL, May 21, 2019 at B10 (behind paywall).

¹¹ ARRC, [A User's Guide to SOFR](#) (April 2019).

¹² ARRC, [SOFR: A Year in Review](#) (April 2019).

¹³ Randal K. Quarles, [The Next Stage in the LIBOR Transition](#), Alternative Reference Rates Committee Roundtable (June 3, 2019).

While ARRC and the Federal regulators have encouraged market participants to stop increasing their legacy portfolios of LIBOR-linked cash transactions with new issuance, tax guidance on the U.S. tax consequences of the transition away from LIBOR will remove one of the biggest obstacles to market participants' transition to the new benchmark—the uncertain tax impact.

Additional Observations Related to Disruption Prior to Cessation

While the FCA's LIBOR Cessation target is still December 31, 2021, there are several pre-Cessation factors that may necessitate or accelerate the parties' adoption of alternative reference rates on existing contracts:

- the increasing volatility of LIBOR as its trading volume further recedes and SOFR's liquidity improves;
- the possible volatility of SOFR, which, unlike LIBOR, will not be tempered by panel banks' appraisal bias;
- the Inter Continental Exchange (ICE), the LIBOR Administrator, could determine that there is an overwhelming preference in the market for LIBOR, and continue to urge investors, borrowers and lenders to pressure the panel banks to continue contributing voluntary bids;¹⁴
- the contentious discussions and possible litigation among LIBOR contract parties over value transfers resulting from the transition from LIBOR to SOFR or another replacement benchmark; and
- the misperception in the market, reinforced by the media, that SOFR is more volatile than LIBOR at quarter and year end periods.

The Tax Aspects of the Problem and Proposed Approach to Guidance

If the terms of a debt instrument are significantly modified, for Federal income tax purposes there is a deemed exchange of the old debt for a new (modified) debt instrument. The exchange can have important tax consequences for the parties. Potential tax consequences include the recognition of taxable gain or loss for the lender, or debt discharge income for the borrower. I.R.C. §§ 1001 and 1274. Moreover, the tax consequences of the deemed exchange can arise without generating actual cash to pay any ensuing tax liability.

We note in passing that there are many other provisions of the tax law that could be similarly triggered, such as an effective date provision applying to instruments issued after a specified date, if the replacement of an existing index is viewed as anything other than a continuation of the original agreement. Thus, although the following analysis focuses on the deemed exchange rules for debt instruments, substantially similar issues may exist elsewhere. For that reason, the ideal approach may be for the tax law to simply disregard any replacement of an existing index that would not be considered to be a significant modification under the deemed exchange rules applicable to debt instruments.

¹⁴ Recent reports from the EU suggest that may happen with respect to a "reformed" Euribor under the EU Benchmark Regulation, instead of proceeding with its original proposal for a new risk-free reference rate, "Eonia".

Treasury regulations aim to address the uncertainty concerning when the modification of a debt instrument results in a deemed exchange of the old debt instrument for a new instrument. Treas. Reg. § 1.1001-3. In general, a modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Treas. Reg. § 1.1001-3(c)(1)(i).

Assuming that a modification has taken place, the parties must next determine whether it is “significant” and therefore treated as an exchange of the original debt instrument for a modified instrument. This is a facts-and-circumstances test. The general rule of the regulations is that a modification is significant if the legal rights or obligations being changed and the degree to which they are being changed are economically significant. Treas. Reg. § 1.1001-3(e)(1).

A set of bright line tests and safe harbors provide additional guidance. These tests relate to changes involving: ministerial acts, annual yield, timing and amount of payments, prepayments, and new obligors. Treas. Reg. § 1.1001-3(e). For example, Treasury regulations provide that a change in yield is a significant modification if the change exceeds the greater of 25 basis points or five percent of the original yield on the instrument. Treas. Reg. § 1.1001-3(e)(2)(ii).

As far as the tax issues are concerned, part of the problem is a circularity in the existing rules defining a significant modification to a variable rate debt instrument. In theory, even if replacing LIBOR with another index were considered to be a modification, it could avoid being considered a significant modification under an objective, bright-line test in the existing loan modification regulations, which compares the yields on the hypothetical fixed-rate debt instruments that would be produced at the time of the modification by the original index and the replacement index. If the yields do not vary by more than 25 basis points (or five percent of the original yield), there is no significant modification. This reflects the theory that such a minor modification may be necessary for business or commercial reasons and would not reflect a fundamental change to the parties’ original business deal at the time the loan was originated. It could be contrasted, say, to an agreement to replace one index with another index producing a substantially lower rate at the time of the agreement, where the change was agreed to by the lender to avoid a voluntary prepayment or refinancing of the loan as a result of changing market interest rates, or a replacement designed to produce a higher rate, agreed to by the borrower to avoid having the loan called following a deterioration of its credit quality or a default on various covenants.

While this rule works well in normal circumstances, if the original index is being replaced because it is defective or potentially defective as an indication or expression of the parties’ original business deal, it may be difficult or impossible to preserve that deal with a replacement index or formula if the parties are restricted to using a replacement that would produce a yield that is no more than a specified amount (e.g., 25 basis points or 5 percent) higher or lower than the yield produced by the defective index they are seeking to replace. That is because the baseline itself is no longer reliable.

When the decision is finally made to replace LIBOR, because it is defective or on the road to becoming defective or obsolete, LIBOR itself, as quoted in the markets, may no longer be an accurate benchmark or baseline of the parties’ original intentions and agreement. Accordingly, it may not be a suitable standard to use for determining whether they have acted, fundamentally, for the purpose of preserving their original economic arrangement—and not for the purpose of modifying the economics of that arrangement.

With a defective or potentially defective index, is there an argument that the replacement would not even be a “modification?” As a theoretical matter, a party adversely affected by the unavailability or unreliability of LIBOR quotes might seek a judicial resolution in the nature of an interpretation of the

existing LIBOR reference, or a reformation of the agreement to supply a term necessitated by a mutual mistake of fact regarding the expected continued availability of suitable LIBOR quotes. Such a judicial determination would not properly be considered to be a modification of the original agreement. In addition, under the tax concept of “origin of the claim,” a voluntary agreement to replace LIBOR with a mutually acceptable alternative could be viewed as tantamount to an out-of-court settlement of such potential litigation, and therefore could also be considered to be a continuation of the parties’ original agreement and not an alteration of that agreement.

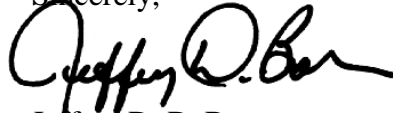
Even if this “no modification” argument were valid, we recognize that such a mutual agreement could, in theory, reflect factors other than a defective or potentially defective term in the agreement — such as a change in the borrower’s credit quality — and could therefore be viewed economically as a “disguised modification.”

To deal with this, we recommend that the Treasury or IRS adopt formal guidance implementing the following general approach. Where the new agreement conforms to a regulatory, governmental, or broad industry consensus as to the suitability of the replacement index, the replacement should not be considered to be a significant modification. In other cases, if the parties’ agreed upon replacement is selected in good faith with the principal purpose and effect of replacing LIBOR with an index or formula selected to preserve the parties’ original commercial agreement at the time the loan was originated, taking into account the facts and circumstances at that time, it will not be considered to be a significant modification. To illustrate the second rule, in cases where the parties have not selected a replacement index endorsed by regulators, governments or a broad industry group, it should not be permissible to take into account post-origination deterioration in the borrower’s credit quality to arrive at a replacement index or formula that would compensate the lender for the resulting increased risk. Other details of our proposed approach are described in the Executive Summary above.

* * *

In conclusion, addressing the tax issues associated with the transition away from LIBOR is critical to the stability of financial markets, the real estate industry, and the overall economy. The Executive Summary above summarizes an approach we believe the Treasury Department and IRS should seriously consider. The Real Estate Roundtable looks forward to working with you to determine an appropriate path forward that provides certainty to American businesses and markets.

Sincerely,



Jeffrey D. DeBoer
President & Chief Executive Officer
The Real Estate Roundtable