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Shift from Old Reference Rates Won’t Trigger Tax, IRS Says

By Lydia O'Neal and Nicola M. White Oct 8, 2019

- • No capital gains tax on switch to new benchmark interest rates
- • Proposed rules hew closely to banks’ and regulators’ requests

The IRS said it won’t apply capital gains tax to debt instrument changes made as part of the shift to new reference rates, seven years after a derivatives rate manipulation scandal rocked financial markets.

As financial markets turn from interbank offered rates to alternative benchmark interest rates for loans, bonds, derivatives, and other financial instruments, contracts for those instruments will have to be amended to reference the newer benchmarks over the next couple of years. Regulators and financial firms can rest assured that the modifications should have no tax consequences, in light of IRS proposed rules (REG-118784-18) released Oct. 8.

The proposed rules—which traders, banks, and other market participants can follow even while not yet final—were meant to provide widespread relief and can be applied broadly to virtually any financial contract that has a reference rate, a senior Treasury Department official said during an Oct. 8 call with reporters. The department hopes to make them final as quickly as possible, ideally within the next few months, the official added.

The White House Office of Management and Budget review of the proposals—from Aug. 28 to Sept. 25, according to the office’s website—had no effect on the substance of the rules, the official said.

Safe Harbors

The proposed rules create two routes to ensuring the changes to the contracts cause the instruments to have the same market value, and therefore no tax consequences, and state that Treasury reserves the right to add more.

Through one route, the difference between the historic averages of the rates used before and after the modification must be within 25 basis points, or a quarter of a percentage point, of one another. Through the other route, the parties to the debt instrument must be unrelated and find that the market values of the original and modified contracts are equivalent.

The Alternative Reference Rates Committee, a group of regulators and banks, had asked the IRS and Treasury to quickly eliminate tax consequences stemming from those contract changes so that the transition to new “risk-free rate” benchmarks can be a smooth one. The department, an ex-officio member of ARRC, took these requests into account, another senior Treasury official said on the call.

“Timely guidance on these topics is critical to a successful transition of a very large number of existing IBOR-based contracts to the replacement RFRs,” the committee wrote in an April letter. “The ARRC believes that such early modifications will help ensure an orderly market transition away from IBORs, and therefore any significant tax barriers to completing them should be addressed as promptly as possible.”

Reaction

Tom Wipf, vice chairman of institutional securities at Morgan Stanley and the committee's chair, praised the guidance in an ARRC statement.

"The Treasury action today provides much more clarity around the tax issues related to converting legacy trades," he said. "This clears the path forward, and I strongly encourage all market participants to take this opportunity to transition away from LIBOR and begin adopting the Secured Overnight Financing Rate."

While the safe harbors diverged somewhat from ARRC's requests, the rules took into account the risk that the absence of this kind of relief could stunt the transition to new reference rates by leading to contract breaches, said Kristen Garry, a partner at Shearman & Sterling who advises financial institutions on financial products-related issues.

"My initial reaction was that the proposed regs are very comprehensive, clear, and fair," she said, adding that allowing market participants to rely on them before they're final was very welcome.

Libor Scandal

In 2011 and 2012, financial regulators in the U.S., the U.K., and other countries began looking into multiple banks' manipulations of the benchmark London Interbank Offered Rate, or Libor, for profit, and found that the behavior stretched back years.

U.S. banks use Libor as a reference to set interest rates on trillions of dollars of debt instruments and it can affect rates on home and car loans, corporate bonds, and student debt. It's set to phase out by the end of 2021.

Banks and financial regulators advocated for a transition to a new benchmark, the secured overnight financing rate, and for the tax consequences of the shift to be minimal.

U.S. accounting rulemakers also are tackling the fallout from Libor's looming end. The Financial Accounting Standards Board in September issued a proposal that would ease some of the normal accounting requirements that kick in when a business has to change an interest rate in a loan or derivatives contract.

Under the plan, if a loan, lease, or debt contract has to be changed to insert a new interest rate, the modification could be accounted for as a continuation of the transaction rather than a brand new deal. Similarly, businesses wouldn't have to unravel certain derivatives contracts tied to Libor to figure out if swapping out an interest rate disqualifies them from a favorable accounting treatment called hedge accounting.

Comments on the FASB proposal were due Oct. 7.

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