

Legal Alerts

2023 Reminder to Issuers and Borrowers of LIBOR-Based Tax-Exempt Bonds: Now is the Time to Protect the Tax-Exempt Status of Bonds in Anticipation of Upcoming Discontinuation of LIBOR

01.04.23 01.07.26

As we welcome 2023, and the final six months of certain London Interbank Offering Rates ("LIBOR"), issuers and borrowers of LIBOR-based tax-exempt bonds should evaluate whether changes to their financing documents are necessary to implement a replacement rate, while avoiding changes that could negatively affect the tax-exempt status of those bonds.

As many are aware, the Intercontinental (ICE) Benchmark Administrator plans to cease publishing the overnight, one-month, three-month, six-month and twelve-month U.S.-dollar LIBOR after June 30, 2023. As a result, existing debt instruments that use LIBOR as the reference rate for determining their interest rates may need to be modified.

In general, modification of a tax-exempt municipal bond may be treated as a significant modification that constitutes a "reissuance," and a reissuance could call into question whether interest on the modified bond continues to qualify for tax exemption. The Treasury Department and Internal Revenue Service ("IRS") have adopted a new regulation (Treas. Reg. §1.1001-6) designed to support an orderly transition of LIBOR-based instruments to new reference rates. If a modification of a LIBOR-based instrument made between March 7, 2022 and June 30, 2024, is structured to qualify as a "covered modification" under Treas. Reg. §1.1001-6, the modification will not result in a reissuance. Issuers and borrowers should consult with bond counsel before finalizing changes to the terms of a tax-exempt financing instrument.

Treasury Regulation Facilitates Transition From LIBOR

LIBOR as Reference Rate Discontinued After June 30, 2023. The Intercontinental (ICE) Benchmark Administrator, as administrator of the London Interbank Offering Rate ("LIBOR"), has announced that its publication of overnight, one-month, three-month, six-month and twelve-month U.S.-dollar LIBOR will cease following June 30, 2023. As a result, various types of existing debt instruments, including loan contracts and municipal bonds, that contain provisions requiring the use of LIBOR as the reference rate for

determining the interest rate on the debt instrument may need to be modified.

These modifications may raise federal tax issues. For example, the modification of a loan contract may be treated as a taxable exchange of property for other property differing materially in kind or extent for purposes of §1001-1(a) that gives rise to gain or loss, and the modification of a tax-exempt municipal bond may be treated as a significant modification that constitutes a "reissuance" under §1.1001-3 that would raise a question whether the interest on the modified bond continues to qualify for tax exemption.

For such a modification to transition from LIBOR to be treated as a "covered modification" (described below) that will not result in a taxable exchange or "reissuance" of the debt instrument, the modification must be made not later than one year after the discontinuance of LIBOR, i.e., by June 30, 2024.

Treasury Regulation §1.1001-6 Facilitates "Covered Modifications" Made to Transition From LIBOR. In an effort to minimize potential market disruption and facilitate an orderly transition from LIBOR to other reference rates, the Treasury Department and Internal Revenue Service ("IRS") adopted Treas. Reg. §1.1001-6. The basic purpose of §1.1001-6 is to facilitate modifications to contracts that are made to transition from LIBOR to new reference rates, while preserving the same business and economic terms.

Treas. Reg. §1.1001-6 applies to a modification of the terms of a contract that occurs on or after March 7, 2022. In general, the operative rules of §1.1001-6 provide that certain "covered modifications" of a contract made to transition from LIBOR to a "qualified rate" will not result in a taxable exchange of property under §1.1001-1(a) or a reissuance of a debt instrument under §1.1001-3. A "covered modification" is a modification made to transition from a discontinued interbank offered rate such as LIBOR to a "qualified rate" and to make "associated modifications," if any, of technical, administrative, or operational terms of the contract reasonably necessary to implement the covered modification. The operative rules also permit certain "qualified one-time payments" to be made to compensate a party for all or part of the basis difference between the discontinued interbank offering rate and the interest rate benchmark used for the new qualified rate.

"Modification" of Contract Broadly Defined. For the purposes of §1.1001-6, a "modification" of a contract, including a debt instrument such as a tax-exempt municipal bond, is defined broadly to include any modification of the terms of the contract, regardless of the form of the modification. For example, a modification could include an exchange of one contract for another, an amendment to an existing contract, or a modification accomplished indirectly through one or more transactions with third parties, regardless of whether the modification is evidenced by an express agreement, conduct of the parties, or otherwise. Therefore, when considering modifications to a tax-exempt bond to transition from LIBOR to another reference rate, the issuer of a tax-exempt bond should evaluate, in advance of any agreement with the bondholder and in consultation with bond counsel, whether the modification would be treated as a "covered modification" under §1.1001-6.

"Qualified Rates." The question whether a modification of a debt instrument will be treated as a covered modification depends on whether the new reference rate is a "qualified rate." Under §1.1001-6(h)(3)(ii), a

qualified rate is any of the following rates having a benchmark that is reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds:

(A) A "qualified floating rate" as defined in §1.1275-5(b), but without the requirement that any fixed multiple applied to the qualified floating rate must be greater than .65 but not more than 1.35. Such a qualified rate includes "SOFR," which is the Secured Overnight Floating Rate developed by the Alternative Reference Rates Committee ("ARRC") and published each business day on the website of the Federal Reserve Bank of New York (the "New York Fed");

(B) An alternative, substitute or successor rate selected, endorsed or recommended by the central bank, reserve bank or monetary authority as a replacement for LIBOR in that governmental jurisdiction;

(C) A rate selected, endorsed or recommended by ARRC as a replacement for LIBOR, so long as the New York Fed is then an *ex officio* member of ARRC-e., SOFR, as noted above, as well as CME Group's forward-looking one-month, three-month, six-month and twelve-month Term SOFR Reference Rates ("Term SOFR") recommended by ARRC on July 29, 2021, and also published each business day on the website of the New York Fed;

(D) A rate determined by reference to one of the rates described in (A), (B) or (C) above by adding or subtracting a specified number of basis points to or from the rate or by multiplying the rate by a specified number; and

(E) A rate identified for purposes of §1.1001-6 by the IRS and published in the Internal Revenue Bulletin.

"Waterfall" of "Fallback Rates" May Be Qualified Rate. A single qualified rate also may be comprised of one or more "fallback" rates. A "fallback" rate is a rate, such as 30-day Term SOFR, which the parties to a contract agree will become operative following the discontinuance of LIBOR. For example, a "waterfall" or series of "fallback" rates specified in a contract may constitute a qualified rate, but only if each individual fallback rate in the waterfall separately meets the requirements of a qualified rate. If it is not possible to determine at the time that a modification is being tested as a covered modification whether a fallback rate will satisfy the requirement that it must be reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds, then that fallback rate, and any waterfall of fallback rates that includes that fallback rate, will not be treated as a qualified rate. If, however, the likelihood that any value will ever be determined under the contract by reference to a particular fallback rate that would not be a qualified rate is "remote," then it is treated as a qualified rate.

Depending on the manner in which a fallback rate becomes operative, it may need to be tested as a covered modification both at the time the debt instrument is modified and at the time the fallback rate becomes effective. For example, if the fallback rate becomes effective by operation of the terms of the debt instrument or as the result of the exercise of a unilateral option by the holder of the debt instrument, the fallback rate would not need to be retested as an additional modification, whereas a fallback rate that becomes effective only by mutual agreement of the parties would need to be retested as an additional

modification. In addition, a fallback rate may need to be retested at the time it becomes effective in order to confirm that it continues to be a qualified rate.

"Noncovered Modifications." Certain modifications of contracts are excluded from being treated as "covered modifications." These noncovered modifications are viewed as being beyond the scope of facilitating the transition from LIBOR to another qualified rate while preserving the same business and economic terms of the unmodified contract. Under §1.1001-6(j), each of the following modifications that change the amount or timing of cash flows under the contract is a noncovered modification:

1. The modification is intended to induce one or more parties to perform any act necessary to consent to the replacement of LIBOR with a qualified rate, make associated modifications, if any, and make a qualified one-time payment, if any—for example, an agreement by the issuer of a debt instrument to add an additional 10 basis points to the basis adjustment spread to induce the holder to consent to the LIBOR replacement modification;
2. The modification is intended to compensate one or more parties for a modification other than one that replaces LIBOR with a qualified rate, makes associated modifications, if any, and provides a qualified one-time payment, if any—for example, an agreement by the issuer of a debt instrument to add 30 basis points to the interest rate to compensate the holder for agreeing to modify a customary financial covenant for the issuer's benefit;
3. The modification is a concession to a party experiencing financial difficulty or a concession obtained by one party to account for a deterioration in the credit of the other party—for example, an agreement by the holder of a debt instrument to reduce the interest rate by 50 basis points to assist an issuer that is experiencing financial difficulties;
4. The modification is intended to compensate one or more parties for changes in rights or obligations that are not derived from the contract being modified—for example, an agreement by the issuer to add 30 basis points to the interest rate on one debt instrument in order to induce the holder to agree to modify customary financial covenants made by the issuer in a different debt instrument that is also held by the holder; and
5. The modification is identified in future guidance by the IRS as having a principal purpose of achieving a result that is unreasonable in light of the purpose of §1.1001-6.

The federal tax consequences of each of the foregoing types of "noncovered modifications," if made, would need to be analyzed separately from any covered modification under the general rule for a taxable exchange of property under §1.1001-1(a) and the rule for a significant modification of a debt instrument under §1.1001-3.

No Adverse Effect Opinions. In a situation where the issuer and holder of a debt instrument that consists of a tax-exempt bond are considering an agreement to modify the bond in order to transition from LIBOR to a

new reference rate such as SOFR, the financing documents for the bond may require, or the holder of the bond may request, that the issuer provide an opinion of bond counsel to the effect that the modification of the bond will not adversely affect the tax-exempt status of interest on the bond (a "no adverse effect opinion"). In order to provide a no adverse effect opinion, bond counsel would need to conclude that the modification is a covered modification made to transition from a discontinued interbank offering rate, such as LIBOR, to a qualified rate. In order to reach that legal conclusion, bond counsel may require that the issuer and holder of the bond provide certifications to the effect that no facts and circumstances exist that would show that the proposed modification is a noncovered modification of the type described above.

Alternative Analysis of Noncovered Modifications. Even if all or part of the modification is determined to be a noncovered modification, bond counsel could conclude that the noncovered modification is not a significant modification of the terms of the bond that would cause the bond to be treated as "reissued" under the general rule set forth in §1.1001-3. Further, even in the event that the noncovered modification of the bond would cause it to be treated as "reissued," bond counsel nonetheless may be able to provide a no adverse effect opinion if the issuer takes the steps needed to qualify the reissued bond as a newly issued tax-exempt current refunding bond used to refund the prior bond. Depending on whether the reissued bond is a tax-exempt governmental bond or a tax-exempt private activity bond, these steps could include, for example, testing whether the reissued bond remains eligible to be treated as a governmental bond or a qualified 501(c)(3) bond under the applicable private activity bond regulations, filing a new Form 8038-G or Form 8038 Information Return for the reissued bond, holding a TEFRA hearing and obtaining a public approval for the issuance of the reissued bond, and obtaining volume cap for the reissued bond.

The issuer also would need to comply with the arbitrage rebate requirement, if otherwise applicable, with respect to the prior bond deemed to be currently refunded and retired by the reissued bond. The date on which the prior bond is treated as retired would be the final computation date for any rebate amount due with respect to gross proceeds of the prior bond. Any such rebate amount would be payable to the United States with Form 8038-T filed with the IRS not later than 60 days after that final computation date.

Certain Economic or Financial Considerations. An issuer that modifies a tax-exempt bond to transition from LIBOR to SOFR, for example, may wish to consider whether certain other adjustments should be made to SOFR as the new qualified rate on the bond, regardless of the tenor of the SOFR rate. For example, because SOFR is a taxable rate, it may be appropriate that the applicable SOFR rate on a tax-exempt bond held by a corporation be multiplied by 79% (0.79) to take account of the federal corporate tax rate of 21% that would otherwise apply to interest received on the bond if it were taxable. Also, because SOFR rates reflect essentially risk-free interest rates, whereas LIBOR was not considered a risk-free rate, there is an understanding that SOFR rates, regardless of the tenor, may be lower than what otherwise would be a LIBOR rate.

Featured People

[Allison C. Schwartzman](#)

[Principal|Seattle](#)

[206.447.6406 a.schwartzman@foster.com](#)

[William G. Tonkin](#)

[Principal|Seattle](#)

[206.447.8967 william.tonkin@foster.com](#)

Related Areas

- [Municipal Law](#)
- [State & Local Government](#)
- [Public Finance](#)
- [Public Finance & Municipal Law](#)