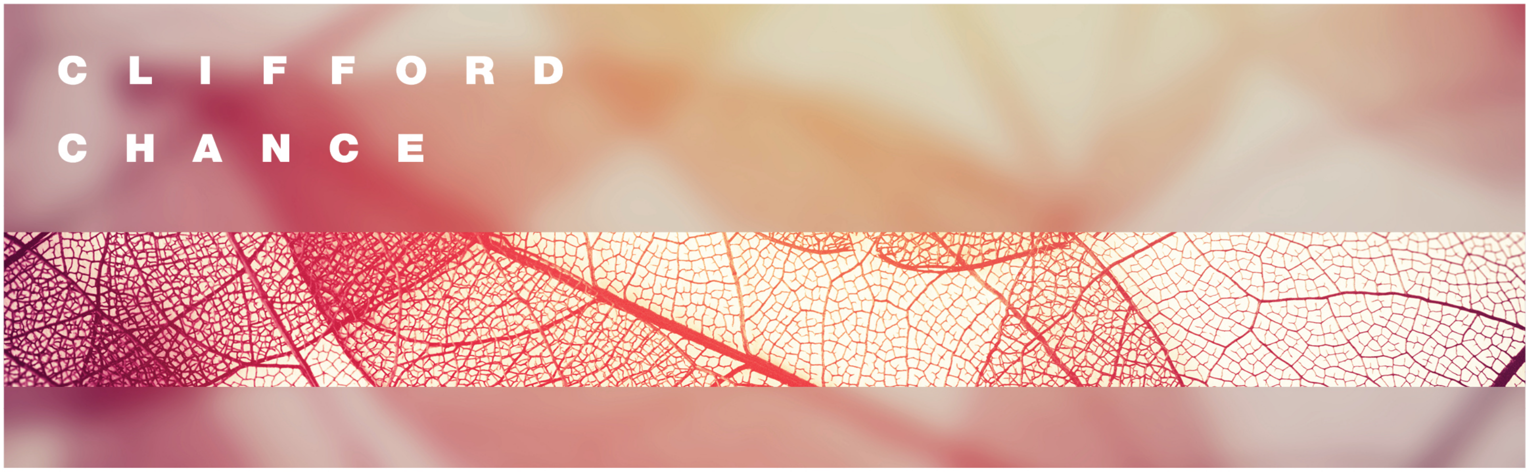

TRANSITION FROM LIBOR TO AN ALTERNATIVE BENCHMARK RATE RAISES CONCERNS PARTICULAR TO REMICS

On October 8, 2019, the U.S. Department of Treasury proposed regulations that would address the tax issues for Real Estate Mortgage Investment Conduits ("**REMICs**") that could arise from the impending transition away from interbank offered rates ("**IBORs**") as reference rates for floating rate debt (available here, the "**Proposed Regulations**"). As discussed in this briefing, the Proposed Regulations include some important conditions that – if adopted as proposed – will require close oversight to confirm that they are met. Given the severity of the potential ramifications of not meeting these requirements, it is critical that all participants of a REMIC deal are aware of, and seek legal advice regarding, the tax aspects of switching to a replacement benchmark rate.

Background

In 2017, the U.K. Financial Conduct Authority (the "**FCA**"), the regulator that oversees the London interbank offered rate ("**LIBOR**"), announced its intent to transition away from all currency and term variants of LIBOR, including U.S. dollar LIBOR ("**USD LIBOR**"), by the end of 2021. Although some tenors of LIBOR may continue to be produced after the end of 2021, these rates will no longer be sustained through the mechanisms of the FCA persuading or obliging panel banks to participate and, consequently, risk not being representative of underlying market conditions. Since 2017, regulators in various countries have put great efforts into studying and selecting rates that are most appropriate to replace the interbank offered rates ("**IBOR**s") that have traditionally been used around the world. In the United States, for example, the Alternative Reference Rates Committee (the "**ARRC**") has selected the Secured Overnight Financing Rate ("**SOFR**") to recommend as an appropriate replacement for USD LIBOR. Meanwhile, market participants have been urged to formulate and implement their individual transition plans for both future transactions and legacy contracts.

This transition away from IBORs will bring with it certain serious tax implications. In particular, transitioning a debt instrument from an IBOR-based rate to a rate based on a different reference rate could result in a modified debt instrument being treated as a new debt instrument for tax purposes. In such case, holders would be required to recognize gain or loss on a deemed exchange of the original instrument for the modified version of that instrument. The stakes are even higher for REMICs, because these entities will lose their tax advantaged status if:

- their regular interests (which are treated as debt instruments for tax purposes) are deemed to be exchanged for new instruments; or
- more than a *de minimis* amount of the mortgage loans held by REMICs are considered to be new debt instruments.

As discussed below, the Proposed Regulations provide helpful guidance around preventing the tax issues for REMICs that could arise from the impending transition away from IBORs.

When are modifications generally deemed to involve a taxable exchange?

The modification of the terms of a debt instrument can be treated as a taxable exchange of that instrument if the modification is "significant". A modification under current rules generally includes any alteration of a legal right or obligation of the issuer or a holder of a debt instrument. Subject to certain exceptions, a modification for these purposes generally excludes an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument, either automatically or as a result of the exercise of an unilateral option (by either an issuer or a holder of the debt instrument). Unless the change from an IBOR rate to an alternative rate occurs by operation of the instrument, either in a mechanical way that does not include any negotiation between the parties, or pursuant to a unilateral right of one party to the instrument, the change from an IBOR-based rate to an alternative reference rate could be treated as a "significant modification" under existing law and regulations.

Proposed Regulatory Relief

In response to escalating concern regarding the tax consequences of the impending IBOR phaseout, the Department of Treasury released the Proposed Regulations to address the most critical issues brought to its attention by agencies and associations such as the ARRC and the Structured Finance Industry Group. The Proposed Regulations have proposed applicable date provisions intended to allow taxpayers to rely on their provisions prior to the formal adoption date. At their core, the Proposed Regulations generally provide that an alteration of the terms of a debt instrument to replace, or to provide a fallback to, an IBOR-referencing rate as well as any "associated alterations" will not be treated as a modification for tax purposes if such alterations comply with specified rules. The following three-prong test generally summarizes the proposed requirements for permitted alterations:

1) the IBOR reference rate must be replaced by a "qualified rate" that is specifically listed in the Proposed Regulations (e.g., SOFR and certain permitted rates derived from SOFR);

2) the fair market value of the debt instrument after the alteration must be substantially equivalent to the fair market value of the instrument before the alteration, taking into account a one-time payment to holders of the debt instrument to offset any changes in value of the instrument that would result from adopting the qualified rate; and

3) the new rate must be in the same currency as the IBOR rate it replaces.

The Proposed Regulations go on to lay out guidelines for determining whether each of these conditions is met. In addition, to address concerns specific to REMICs, the Proposed Regulations offer the following regulatory relief:

- If a REMIC's regular interests are amended to provide either a replacement for IBOR or a fallback rate in a way that is permitted under the Proposed Regulations, the amendment generally will not be taken into account when determining whether the terms of the regular interests are fixed on the REMIC's start-up date.
- Such permitted alterations will not cause a REMIC regular interest to no longer be treated as such simply because the revised terms permit the rate of the regular interest to change from an IBOR-referencing rate to a fallback rate.
- In the event of such permitted alterations, a REMIC will not be treated as:
    - having an impermissible shortfall if payments on the regular interests are reduced by reasonable costs associated with the alteration; or
    - receiving a prohibited contribution if such reasonable costs are paid by a party other than the REMIC.

We would recommend that additional guidance be issued with respect to the modification of IBOR-based underlying mortgage loans held by a REMIC.

- The Structured Finance Association, November 25, 2019 Letter to the Internal Revenue Service

Additional Transition Concerns for REMICs

As currently drafted, the Proposed Regulations do not account for all of the issues likely to arise in the phaseout of IBOR. For example, these rules do not currently provide clear guidance in situations where parties to an instrument want to replace USD LIBOR with anything other than SOFR. Although the Proposed Regulations list a number of qualified rates other than SOFR, each of those qualified rates is either a general description of an unspecified rate or is a specified rate that is in a currency other than USD, and thus cannot be used to replace USD LIBOR. In addition, these rules do not account for subsequent alterations of a replacement rate. For instance, if an instrument is initially altered to replace USD LIBOR with compound average SOFR, it is unclear whether the new rules will protect a subsequent alteration replacing that SOFR-based rate with Term SOFR once it becomes available (or any other alternative reference rate contemplated lower down in the waterfall of replacement rates recommended by the ARRC).

Furthermore, in their current form, the risk of inadvertently falling outside of these new rules for REMICs (for both their regular interests and the mortgage loans they hold) is significant and the consequences of doing so are severe. Although the REMIC-specific rules in the Proposed Regulations are intended to allow a REMIC to make changes to its regular interests without causing the entity to become disqualified as a REMIC, REMICs must still meet the above described three-prong test with respect to the mortgage loans it holds, with no special exception. Even with respect to a REMIC's regular interests, the Proposed Regulations leave some potential ambiguity, particularly if parties want to adopt a replacement benchmark rate that is not explicitly listed in the Proposed Regulations. In addition, amending the terms of a REMIC's regular interests will come at a cost, a REMIC will either have less funds available to pay holders of its regular interests or alternatively will receive funds from an outside source to assist the REMIC with these costs. Generally, these should fall under "unexpected expenses" (which are permissible to treat essentially as a realized loss from the mortgage loans held by the REMIC). Moreover, the Proposed Regulations provide that reasonable costs incurred by a REMIC to effectuate a modification that otherwise qualifies under the new rules can be ignored for purposes of determining whether the REMIC's regular interests qualify as regular interests. How these costs are shared among the REMIC's holders of regular interests may, however, create issues. The costs of an IBOR-related change may be substantial, and may be especially great in the context of a REMIC since the documentation for a REMIC might not contemplate or allow for such changes. In such cases, the REMIC will need to amend its constituent documents, a process typically accompanied by a suite of required legal opinions.

In addition, REMICs may face less obvious challenges depending on how the servicing and pooling agreements are designed and what sorts of changes are precluded. For example, in many situations, agreements are entered into that prohibit the amendment of any underlying mortgage loan except in the event that default of such loan is imminent. It will be necessary to amend servicing agreements to permit particular modifications, and the servicers or trustees may expect indemnification from the REMIC or other parties for the manner in which the transition from IBOR is structured or executed. Accordingly, some "road bumps" should be expected in any transaction's transition away from IBOR.

The Path Forward

The Proposed Regulations provide generally favorable guidance around how to navigate this unprecedented shift. IBOR phaseout could have a materially adverse impact on REMIC transactions that do not meet the conditions specified in the Proposed Regulations and any further guidance. Anyone involved with a REMIC transitioning its regular interests and mortgage loans from an IBOR-based rate to an interest rate based on an alternative reference rate needs to carefully plan their steps and monitor the actions of others throughout each stage of the transition process to avoid adverse tax consequences for the REMIC.

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