August 9, 2021

Treasury and IRS colleagues,

The Alternative Reference Rates Committee (the "ARRC") submits these comments to the U.S. Treasury Department and the Internal Revenue Service (the "IRS") (together, "Treasury") in support of certain potential changes to the substantial equivalence of fair market value requirement contained in proposed Treasury regulations section 1.1001-6(b)(2) (the "fair market value requirement"). In addition, these comments address the timing of the finalization of proposed Treasury regulations section 1.1001-6. The proposed and anticipated final versions of Treasury regulations section 1.1001-6, addressing the modification of contracts in connection with the expected discontinuation of interbank offered rates ("IBORs"), are referred to herein as the "proposed regulations" and the "final regulations," respectively.

Alternatives to the Fair Market Value Requirement

Exceptions Approach

Under the proposed regulations, for a rate to replace an IBOR in a contract without a resulting tax event under Section 1001, the post-modification fair market value of the contract must generally be substantially equivalent to the pre-modification fair market value of the contract.

The ARRC understands that Treasury is evaluating an approach to the final regulations that would replace the fair market value requirement with enumerated exceptions to the application of the final regulations for modifications not intended to be within the scope of those regulations. Two potential exceptions would be: (1) the payment of a consent fee (the "consent fee exception") and (2) a rate modification made as the result of the deterioration of the credit of an obligor or counterparty (the "workout modification exception"). The ARRC understands that these excluded modifications would be tested separately under the principles of Treasury regulations section 1.1001-3 or 1.1001-1(a), as applicable, and therefore would not automatically prevent an IBOR modification transaction from being covered by the final regulations. This approach would be consistent with the proposed regulations' treatment of "other contemporaneous alterations and modifications" in proposed Treasury regulations section 1.1001-6(a)(4).[1]

The ARRC supports replacing the fair market value requirement with objective exceptions for consent fees and workout modifications, where such excepted modifications would be tested separately under applicable Section 1001 principles, as described above (the "exceptions approach"). As discussed in the ARRC comment letter submitted on March 12, 2020 (the "ARRC 2020 Letter"), the fair market value requirement creates significant practical obstacles that may delay or hinder market participants from entering into IBOR modifications and thereby impede an orderly market transition. By contrast, an exceptions approach that applies in a straightforward manner would be easier for market participants to implement and would be better aligned with reference rate reform guidance issued by the FASB with respect to GAAP. For

[1] Under proposed Treasury regulations section 1.1001-6(a)(4), for purposes of testing "other contemporaneous alterations and modifications" under the principles of Treasury regulations section 1.1001-3 or 1.1001-1(a), modifications that are covered under proposed Treasury regulations section 1.1001-6(a)(1) through (3) are treated as part of the terms of the contract prior to such other contemporaneous alterations and modifications.

modifications that are treated as related to reference rate reform, the FASB guidance allows parties to undertake a qualitative rather than a quantitative analysis to establish that such modifications do not extinguish the relevant contract.[2] An exceptions approach in the final regulations could similarly allow taxpayers to conclude, without the need to perform individual contract-level value testing, that modifications limited to those intended to effect an IBOR substitution are within the scope of the final regulations.

Financial institutions are central to the process of transitioning outstanding IBOR contracts because they are, in most situations, both the counterparties to IBOR-based derivatives and the lenders on IBOR-referencing loans. Because of the massive numbers of contracts involved, for many financial institutions the process of transitioning these contracts requires the use of standardized and automated processes that can be administered efficiently and quickly by dedicated teams. Individualized review by legal, tax or accounting experts would occur only when a potential contract amendment falls outside of standard parameters. For these reasons, having straightforward, easy to administer rules is crucial.[3]

In addition, the ARRC reiterates its view expressed in the ARRC 2020 Letter that the fair market value requirement is not necessary to ensure that the final regulations apply only to IBOR-related amendments. For contracts between related parties, Section 482 already allows the IRS to adjust transactions that do not reflect arm's length terms. For unrelated parties acting at arm's length, the ARRC believes commercial considerations should be sufficient to ensure that IBOR-related amendments do not result in any inappropriate value transfer; assuming the parties are not making unrelated contemporaneous modifications to their contracts, neither party would have an incentive to give up value unilaterally. Financial institutions, in particular, must balance the objective to preserve the value of their own positions against considerations relating to their legal and regulatory duty to treat customers fairly, which may include concerns regarding litigation, reputational risk and conduct requirements imposed by regulators.[4] Accordingly, the ARRC believes the risk of value transfers among unrelated parties is low and thus does not warrant the compliance burden that the fair market value requirement creates. By contrast, the exceptions approach could provide greater clarity and administrability to parties engaging in IBOR modifications, provided the excepted modifications are clearly delineated.

<u>Consent Fees Exception</u>

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[2] *See* Reference Rate Reform (Topic 848), FASB.ORG (March, 2020), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176174318625&acceptedDisclaimer=true.

[3] In particular, many financial institutions are designing their procedures to follow the IBOR relief issued by FASB, which provides a list of modifications that are generally related and unrelated to reference rate reform. For this reason, as discussed in more detail in the ARRC 2020 Letter, it would be desirable to align the treatment under final regulations with the FASB relief as much as possible.

[4] For example, the UK Financial Conduct Authority ("FCA") has provided guidelines on proper conduct for financial institutions in connection with the LIBOR transition, requiring that they treat customers fairly. Specifically, the FCA prohibits financial institutions from engaging in LIBOR modifications that have the effect of reducing the value of those contracts to the customer, and many financial institutions have implemented procedures to prevent such a situation. See Conduct Risk During LIBOR Transition, FCA.COM, (19/11/2019), https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition ("LIBOR discontinuation should not be used to move customers with continuing contracts to replacement rates that are expected to be higher than what LIBOR would have been, or otherwise introduce inferior terms. We will pay close attention to any case where a contract amendment is made in this way as firms may be failing to meet their obligation to treat customers fairly.").

With respect to consent fees, the ARRC understands that in certain contexts, particularly those involving widely held debt instruments, an obligor may be required as a practical matter to offer a small consent fee to induce holders to consider an amendment replacing an IBOR with a substitute rate. In many cases, such a consent fee would, if tested under the principles of Treasury regulations section 1.1001-3, not give rise to a tax event. Accordingly, provided a consent fee is tested separately under Treasury regulations section 1.1001-3 (or analogous principles for non-debt contracts) and does not prevent the taxpayer from relying on the final IBOR regulations for purposes of testing the IBOR substitution, a consent fee exception would not significantly hinder the process of modifying legacy IBOR-based contracts.

However, if the final regulations include a consent fee exception, it is important that they clarify the scope of the exception and enable a taxpayer to distinguish a consent fee, on the one hand, from a one-time payment or a spread adjustment that is within the scope of the final regulations, on the other hand. In this regard, the ARRC recommends adopting language similar to that contained in the FASB reference rate reform guidance, which clarifies that paying a one-time payment "intended to compensate for the difference in reference rates" is related to reference rate reform and therefore in the scope of the relief provided.

Workout Modification Exception

The ARRC believes that a workout modification exception, if defined in a similarly straightforward way, would be administrable for market participants needing to modify legacy contracts. With respect to the workout modification exception, the ARRC believes that market participants will generally be able to distinguish situations in which a counterparty is making concessions to a distressed borrower or counterparty as opposed to simply replacing an IBOR-based rate with a comparable floating rate. The FASB guidance on reference rate reform treats "[a] concession granted to a debtor experiencing financial difficulty" as a modification that is not generally related to reference rate reform, expressly falling outside the scope of contract modifications otherwise eligible for accounting relief, and therefore many market participants will already be required to analyze such modifications separately from their standard IBOR modification processes.[5]

Value Transfer Exception

The ARRC further understands that, as a variation on the exceptions approach described above, Treasury is considering adding a "value transfer" exception, such that the final regulations would not be available in circumstances where the contractual modifications have the effect of transferring value from one party to another. This exception would be in addition to the consent fee exception and the workout modification exception described above.

The ARRC believes that a value transfer exception would be functionally equivalent to the fair market value requirement contained in the proposed regulations. Accordingly, including such an exception would negate the benefit of the exceptions approach by rendering it at least as, or more, onerous and inadministrable as the fair market value requirement in the proposed regulations. Therefore, should Treasury seek to implement the exceptions approach, the ARRC recommends against including a value transfer exception.

[5] *See* Reference Rate Reform (Topic 848), FASB.ORG (March, 2020), BC 33 at 16 https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176174318625&acceptedDisclaimer=true.

Timing Considerations

The ARRC reiterates the importance of timely issuance of the final regulations. As non-USD LIBOR and certain USD LIBOR settings will be discontinued at the end of 2021, financial institutions are now implementing processes for the transition of contracts referencing those LIBOR settings. These processes reflect tax and other considerations, including accounting, regulatory compliance, information technology and trade management considerations, and generally involve training of dedicated team members. Financial institutions are already modifying contracts based on these processes, and this activity is expected to increase significantly in the fall of 2021. As discussed above, final regulations that align closely with FASB guidance and are easy to interpret and apply to specific situations will make this task easier to accomplish, while burdensome and less clear rules will have the effect of slowing this activity, both by requiring a period where parties need to interpret the rules and then update and implement modifications to the existing processes as well as requiring a greater number of modifications to undergo individualized tax review.

Having clear, administrable final regulations on a timely basis is crucial to providing market certainty and facilitating a smooth market-wide transition. In light of the expected timing of the significant increase in contract modifications, it is important that the regulations be finalized as soon as possible, preferably before the fall of 2021.

We are happy to discuss these issues further or answer any questions you may have.