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November 25, 2019

Internal Revenue Service
US Department of the Treasury
1111 Constitution Avenue NW
Washington, DC 20224

Re: Proposed Guidance on the Transition from Interbank Offered Rates to Other Reference Rates (IRS/REG-118784-18)

Ladies and Gentlemen:

The Mortgage Bankers Association (MBA)[1] respectfully submits these comments on a notice of proposed rulemaking issued by the US Department of the Treasury and the Internal Revenue Service (together referred to as "Treasury") and captioned *Guidance on the Transition from Interbank Offered Rates to Other Reference Rates* (hereinafter "Proposed Regulations").[2]

We appreciate that Treasury recognizes the need to provide guidance on tax consequences arising from transitions away from an existing Interbank Offered Rate ("IBOR") index to a more durable reference rate — transitions made necessary by the anticipated phase-out of the London Interbank Offered Rate (LIBOR) by the end of 2021.

The need for guidance is critical because, under existing tax rules, an alteration of debt instruments (even changes that some may consider minor or unavoidable) can result in a taxable exchange of that debt instrument, which can have far-reaching and unintended tax consequences. Those consequences include the recognition of gain or loss to the issuer and noteholder, and even the disqualification of a securitization trust that holds that debt instrument.

Notably, these potential unwelcome tax results can occur even if the parties are not attempting to alter the economic terms of the original debt instrument but, instead, are seeking only to preserve

[1] The Mortgage Bankers Association is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets, to expand homeownership, and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,300 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies, and others in the mortgage lending field. For additional information, visit MBA's web site: www.mba.org.
[2] *See* 84 Fed. Reg. 54068 (Oct. 9, 2019); available at https://www.govinfo.gov/content/pkg/FR-2019-10-09/pdf/2019-22042.pdf. Unless otherwise indicated, references to specific sections refer to the Proposed Regulations. References to existing regulations refer to sections of "Treas. Reg."

those economics in the face of a change in circumstances not anticipated at the time the loan was originated (*i.e.*, LIBOR's pending phase-out).

These issues affect debt instruments secured by commercial real estate, and also affect issuers and noteholders with respect to real estate mortgage investment conduits (REMICs) and other securitization trusts, under the terms of debt instruments secured by commercial real estate held by the trust. As a result, these issues are important to MBA members engaged in commercial and multifamily real estate lending.

Accordingly, we are pleased that Treasury has issued these Proposed Regulations "to minimize potential market disruption and to facilitate an orderly transition in connection with the phase-out of IBORs and the attendant need for changes in debt instruments and other non-debt contracts to implement this transition" and to "reduce Federal income tax uncertainties and minimize taxpayer burden associated with this transition."[3]

Our comments below are intended to further those objectives. As we describe in more detail, we suggest that Treasury supplement its specific guidance with a general rule of construction that covers circumstances not addressed by that guidance. In addition, we identify specific provisions of the Proposed Regulations that could be clarified to further reduce uncertainty and minimize taxpayer burden.

I. RULES OF CONSTRUCTION

As we noted above, the Proposed Regulations are designed to "reduce Federal income tax uncertainties and minimize taxpayer burden associated with this transition" across each of the categories of possible tax consequences that Treasury identified in the preamble to the proposal.

While Treasury may meet this objective in circumstances that Treasury identifies and considers in the Proposed Regulations, it may not meet the objective in circumstances Treasury does not specifically identify and consider. Treasury faces the impossible challenge of providing guidance to reduce uncertainties and minimize burdens in connection with complex future transactions where the facts and circumstances cannot all be anticipated. As a result, any specific guidance will necessarily prove incomplete and so can lead to unforeseen outcomes at odds with the stated goals of the Proposed Regulations.

Treasury could address this potential issue by supplementing its specific guidance with a general rule of construction that incorporates the framework underlying the Proposed Regulations. Specifically, we recommend that Treasury provide guidance that it will address ambiguity, guidance gaps and unforeseen circumstances by reviewing applicable tax regulations through the lens of whether a particular action —

- Is a reasonable response to IBOR transition; and
- Is reasonably designed to maintain the economics of the original transaction.

[3] *Id*. at 54071.

Under such a rule of construction, taxpayers and Treasury could have a pathway to achieve Treasury's objectives consistently, even in unaddressed circumstances.

II. COMMENTS ON SPECIFIC PROPOSED REGULATIONS

A. "Reasonable costs" and tax opinions (Section 1.860G-1(e)(4))

Section 1.860G-1(e)(4) provides that REMIC regular interests will not fail to qualify as regular interests because they are "subject to a contingency whereby the amount of payments of principal or interest (or other similar amounts) with respect to the interest in the REMIC is reduced by *reasonable costs* incurred to effect an alteration or modification under § 1.1001-6(a)"[4] (and that these costs may be payable by a party other than the REMIC).

For this provision to cover all reasonable costs incurred to effect a modification, it must cover *all* costs incurred to effect a modification, including the costs of obtaining tax opinions. Many governing documents for securitizations require REMIC or other tax opinions by outside counsel for modifications of loans and other collateral held by such securitizations. In the experience of our members, the cost of these opinions can be substantial, especially when dealing with novel issues. Such opinion costs are often regarded as "unanticipated expenses" of the REMIC that are reimbursable by the REMIC out of its funds, unless paid for by a third party.

Similarly, REMIC governing documents for many rated securities require a Rating Agency Confirmation (RAC) in connection with any loan modifications such as a change in the loan's interest rate as would occur with an IBOR-related change. As with the case of REMIC tax opinions, the costs of obtaining a RAC may be substantial and those costs also generally are regarded as "unanticipated expenses of the REMIC" that are reimbursable by the REMIC out of its funds, unless paid for by a third party.

While we believe that the cost of obtaining tax opinions and related RACs would reasonably fall within the term "reasonable costs" in Section 1.860G-1(e)(4), additional comfort as to that interpretation would provide needed certainty as to the treatment of what can amount to substantial costs.

B. "Qualified rates" and "other contemporaneous alterations and modifications" (Section 1.1001-6(a)(4))

Section 1.1001-6(a) proposes the general rule that a change in a debt instrument to replace an existing IBOR-based index with a "qualified rate" does not result in a "modification" of the related debt instrument for tax purposes. Section 1.1001-6(a)(4) provides, however, that "other contemporaneous alterations and modifications" are *not* afforded the protection of that general rule.

Section 1.1001-6(a)(4) illustrates the types of "other contemporaneous alterations and modifications" not afforded the automatic protection of that general rule with an example of a two-

[4] Emphasis added.

part alteration: (1) a replacement of an IBOR-rate to a qualified rate and (2) a simultaneous increase in the rate to account for the deterioration of the issuer's credit since the issue date.

In this example, only the IBOR replacement (alteration (1) above) is afforded the protection of the general rule and so would not be a modification of the related debt instrument for tax purposes. In contrast, the contemporaneous change of the increase in the interest rate to account for the erosion of the issuer's credit would be an "other contemporaneous alteration or modification" that is not subject to the general rule, and so must be tested independently under the general rules for economic significance under Treas. Reg. Section 1.1001-3.

This example is useful for similar, basic, two-part transactions. It does not, however, provide clear guidance as to treatment under the general rule where the functions of the two-part example are accomplished in a single alteration of the debt instrument. In particular, the example does not provide guidance where, for example, the parties select a replacement "qualified rate" based on both the need to change to a more stable index rate (given LIBOR's phase-out) AND a potential desire to account for the deterioration of the issuer's credit as well.

In such a case, would the selection of a "qualified rate" afford the parties no-modification status under the general rule of Section 1.1001-6(a) despite the fact that the replacement rate (together with any related "associated alteration") was selected in part to address changes in the issuer's credit? Or would the transaction be bifurcated and susceptible to challenge as an "other contemporaneous alteration" subject to the general test of economic significance under Treas. Reg. Section 1.1001-3, despite the fact that the replacement qualified rate independently meets the requirement of "substantially equivalent fair market value"?

In our view, the first of the two interpretations above is the better one, given the distinction between the general test of economic significance under Treas. Reg. Section 1.1001-3 and the test for "substantially equivalent fair market value" under Section 1.1001-6(a)(4), and given the underlying goal of the Proposed Regulations to streamline the transition from an IBOR-based rate to a more stable replacement index based on a qualified rate.

We recommend that Section 1.1001-6(a)(4) be modified to confirm that, so long as the replacement rate meets the requirements for a "qualified rate" (and including the requirement for "substantially equivalent fair market value"), there would be no need to also independently test the replacement rate under the general rules of economic significance of Treas. Reg. Section 1.1001-3, irrespective of the motivation of the parties in selecting the replacement qualified rate.

C. "Associated alteration or associated modification" and margin changes (Section 1.1001-6(a)(5))

Section 1.1001-6(a)(5) describes types of "associated alteration or associated modification" that would not be treated as a modification for purposes of the general rule under § 1.1001-6(a).

As described in Section 1.1001-6(a)(5), an associated alteration or modification may be a technical, administrative, or operational alteration or modification, such as a change to the definition of interest period or a change to the timing and frequency of determining rates and making interest payments.[5]

As the provision also describes, an associated alteration or modification may also include the addition of an obligation for a party to make a one-time payment in connection with the replacement of the IBOR-referencing rate with a qualified rate, where the one-time payment is designed to offset the change in value of the debt instrument resulting from that replacement.

This description of associated alterations or modifications, while useful, does not cover the full range of reasonable changes that should be treated as associated alterations or modifications. For example, the description does not address situations where the parties elect to change the margin[6] rather than requiring a party to make a one-time payment to another party. Especially in a CMBS setting where a REMIC structure is in place, a change in margin is a reasonable response to the need to transition away from LIBOR that appears to fall within the intent of this provision.

The description of associated alterations or modifications similarly does not reflect that some CMBS transactions guide the transition from LIBOR to a replacement qualified rate with a formulaic change from a rate of (for example) "LIBOR + A%" to "[Replacement Index] + A% + B%," where B% is the Replacement Index Spread Adjustment. In the case of a change from LIBOR to SOFR, B% would represent the difference between LIBOR and SOFR at the time of the index change. In implementing the index change, the original margin A% would not change. This type of change in margin is also a reasonable response to the need to transition away from LIBOR.

In addition, the description of associated alterations or modifications does not reflect that not every floating-rate CMBS transaction currently based on LIBOR contains the Replacement Index Spread Adjustment concept and that the formulaic change on such transactions might instead be from "LIBOR + A%" to "SOFR + C%." In such cases, the change in the formal margin, *i.e.,* from A% to C%, is another reasonable response to the need to transition away from LIBOR that should be an "associated alteration or modification" where the change yields an otherwise acceptable rate under the Proposed Regulations.

The fact that the descriptions of associated alterations or modifications in the Proposed Regulations do not reflect that a change in margin can be an "associated alteration or modification" creates uncertainty with a variety of seemingly reasonable responses to the need to transition away from LIBOR that would appear to fall within the intent of this Section.

Accordingly, we recommend that Section 1.1001-6(a)(5) be modified to clarify that changes in margins fall within the scope of associated alterations or modifications, by adding an example to

[5] *E.g.,* delaying payment dates on a debt instrument by two days to allow sufficient time to compute and pay interest at a qualified rate computed in arrears.
[6] *E.g.*, from 1-month US$ LIBOR + .30% to SOFR + 2.50%, assuming that the increased margin is designed to maintain the economic *status quo*.

illustrate that margin changes to maintain economic parity would not be treated the same as an increase in rate related to deteriorating credit quality.[7]

D. "Substantial equivalence of fair value" and "arm's length negotiations" (Section 1.1001-6(b)(2)(ii)(B))

Section 1.1001-6(b)(2)(ii)(B) establishes an "arm's length negotiations" safe harbor for a "qualified rate" to meet the requirement for "substantial equivalence of fair market value." That provision does not, however, provide guidance on what indicia of an arm's length's negotiation the parties can rely to satisfy the requirement. For example, is it enough that the parties represent the equivalence of value in a loan amendment or other writing between the parties that evidences the rate change? Are there other factors to which the issuer and noteholder can look?

This issue is of particular concern in the CMBS context because many REMIC governing documents require one party, acting only in a representative capacity, to exercise sole control over IBOR-related index changes, but further require that a different party, also acting in a representative capacity, defer to the first party's results as it implements IBOR-related index changes. Economically, REMIC regular interests are originally modeled based on certain characteristics in the collateral, and these requirements in the governing document are designed to maintain economic coherence within any particular securitization.

To provide certainty in the CMBS setting where REMIC and similar structures are in place, it would be helpful to clarify that, if any parties to a series of modifications negotiate at arm's length, similar conforming changes negotiated by other parties to the transaction would also meet the arm's length standard, notwithstanding that some parties exercised more limited discretion in negotiation. In addition, we recommend that the Proposed Regulations provide that, in the absence of evidence to the contrary, the parties' representation in a formal loan amendment or other writing evidencing that the replacement of the IBOR-based rate is an arm's length negotiation related to the transition to the replacement qualified rate will be respected.

E. "Substantial equivalence of fair value" and "consistent valuation methods" (Section 1.1001-6(b)(2)(i))

Section 1.1001-6(b)(2)(i) provides that taxpayers may use "any reasonable *and consistently applied valuation* method"[8] to establish a "substantially equivalent fair market value" of a replacement qualified rate to the IBOR-related index rate it replaced.

The Proposed Regulations provide no guidance on the meaning of "consistently applied" in this context. As a result, it is not clear whether "consistently applied" for a single transaction means, for example, that the issuer and noteholder have applied the same valuation method for that isolated transaction; or that the same valuation method was applied across the issuer's platform or the noteholder's entire holdings in all similar transactions.

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[7] See also discussion of "other contemporaneous alterations and modifications" at II.B above.
[8] Emphasis added.

Both possible interpretations raise practical issues. In the case of the first approach, how would the parties have any idea of consistency between each other? With respect to the second approach, there can be little certainty in an isolated transaction that the valuation method used is in fact being "consistently applied" across an organization's entire platform or holdings.

These practical issues are a concern in a CMBS setting, where the transaction party charged with implementing the replacement of an IBOR-based index is a third-party agent of the securitization (*e.g.*, the servicer). Further complicating the situation is the fact that the agent's identity can change from time to time over the life of the securitization. Is the test applied at the agent/entity/servicer level? At the securitization-trust level?

We believe that it is inappropriate to impose consistency upon any party acting only in a representative capacity, since such parties will likely need to specifically negotiate each modification they make, a process that would be impaired if the representative were also required to apply a valuation standard for one transaction solely because that representative had negotiated a modification with respect to another transaction.

The meaning of "consistently applied," particularly in the CMBS setting, should be clarified, as follows:

- In the CMBS context where a REMIC structure with multiple tiers is in place, the consistency requirement should be satisfied if the same valuation method is applied, beginning with any index-based collateral, continuing through every REMIC issued from the transaction documents related to that collateral, and finally to every REMIC regular interest issued with respect to those REMICs.
- The consistency requirement should not apply to unrelated REMIC regular interests issued to investors.
- Outside the CMBS context, the consistency requirement should apply only to the noteholder (or beneficial owner of the loan) and the borrower (and its successors) with respect to the particular transaction

We recommend that the Proposed Regulations be modified to confirm the application of the "consistently applied" requirement described above.

F. Historic average of rates and an instrument's LIBOR Determination Date (Section 1.1001-6(b)(2)(ii))

Section 1.1001-6(b)(2)(ii) provides a safe harbor for a "qualified rate" if, on the date of the alteration or modification,

> the historic average of the relevant IBOR-referencing rate does not differ by more than 25 basis points from the historic average of the replacement rate, taking into account any spread or other adjustment to the rate, and adjusted to take into account the value of any one-time payment that is made in connection with the alteration or modification.

In some cases, an IBOR-referencing instrument may call for the IBOR to be determined on a certain "IBOR Determination Date." We suggest that the Proposed Regulation specify that, in such cases, the date convention provided in the IBOR-referencing instrument pre-modification should be the date convention used for purposes of applying the historical average rate safe harbor.

G. Character of one-time payments (Section 1.1001-6(d))

Under Section 1.1001-6(d), the character of a one-time payment made in connection with the alteration or modification "is the same as the source and character that would otherwise apply to a payment made by the payor with respect to the debt instrument or non-debt contract that is altered or modified."

The application of this provision in a CMBS context is not clear. Distribution waterfall structures in place in the typical CMBS transaction treat payments as either principal or interest. The structures do not, however, contemplate one-time payments in connection with LIBOR transition. As a result, there is no applicable payment character to which to refer. Because one-time payments are a way of truing up the replacement rate of interest after the alteration, the inherent character of one-time payments is that of the payment of interest, not principal. Accordingly, we recommend that the Proposed Regulations be modified to direct that such one-time payments be characterized as interest payments.

Also, many CMBS investors will not buy debt instruments or REMIC regular interests with original issue discount (OID). To the extent that one-time payments are interest, it appears that those payments are designed to capture interest rate changes that would likely have been "qualified stated interest" if rates had been set in a post-LIBOR world initially or that are specified by reference to a different interest rate index (*e.g.*, Prime). It would be helpful to OID-sensitive investors to clarify that holdings originally bought without OID continue to be treated as such despite IBOR-cessation-related modifications, including one or more one-time payments.[9]

H. Applicability dates, "taxpayer," "taxpayers," and "the taxpayer and its related parties" (Sections 1.860G-1(e)(5); 1.1001-6(g); 1.1275-2(m)(5))

Several provisions of the Proposed Regulations discuss applicability dates. Depending on the specific provision of the Proposed Regulation, "taxpayers," "a taxpayer," or "the taxpayer and its related parties" may rely on the provisions of various Proposed Regulations prior to the publication of a Treasury Decision adopting the regulations as final.

The application of this "taxpayer" classification for a REMIC structure with multiple tiers is complex. For example, "taxpayers" covered by applicability date provisions may include the REMIC (or each tier thereof), and the holders of the REMIC regular interests. We note here that a holder of a regular interest in one REMIC may also hold regular interests in other REMICs. On

[9] For example, a change from LIBOR to SOFR could require a one-time payment, and a subsequent change from SOFR to *term* SOFR with respect to the same instrument could require another one-time payment.

the other hand, in a tiered REMIC structure, one REMIC may hold all of the regular interests of a lower-tier REMIC.

In addition, many key players involved in implementing IBOR-related changes are third-party service providers that act in a representative capacity only. Also, in the context of the OID regulations, the parties in interest are the issuer of the obligation and the holder, but it is not clear how this correlates with the "taxpayers and their related parties" language.

To facilitate the application of the applicability provisions generally, we recommend that Treasury use uniform language across all applicability date provisions of the Proposed Regulations to the extent appropriate.

In addition, we also recommend that Treasury interpret "taxpayer" language in a way that is reasonable in the CMBS context. We further recommend that Treasury provide this guidance as soon as possible, because the purpose of the applicability date provisions is to provide guidance on the rules of the road that taxpayers can rely on as they make needed amendments to address LIBOR's pending cessation, during the period before Treasury issues final regulations .

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We appreciate Treasury's efforts to provide actionable guidance to reduce federal income tax uncertainties and minimize taxpayer burden associated with the IBOR transition, and we appreciate the opportunity to participate in the process of developing that guidance.

Sincerely,

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President and Chief Executive Officer
Mortgage Bankers Association