LIBOR Transition Regulations Finalized

January 11, 2022

The IRS published final LIBOR transition regulations in the Federal Register on January 4, 2022. The regulations allow modifications of debt instruments and other contracts to replace LIBOR without triggering a reissuance or deemed exchange if certain conditions are met. The Final Regulations are substantively similar to the Proposed Regulations, but new defined terms are introduced, and some substantive differences exist.

Highlights of the Final Regulations

- The Final Regulations will become effective on March 7, 2022. The Proposed Regulations, which were permitted to be relied upon only until the Final Regulations were published, can no longer be relied upon for modifications to debt instruments or contracts occurring on or after January 4, 2022.

- The Final Regulations allow taxpayers to apply them prior to March 7, 2022, but only, other than with respect to the REMIC rules, if the taxpayer (and its related parties) apply the Final Regulations to all transactions that occur prior to March 7, 2022 (although it is unclear whether such taxpayers would have to apply these rules to transactions occurring prior to January 4, 2022). There does not appear to be a requirement that all parties to a transaction treat the transaction consistently.

- The Final Regulations treat transactions described in section 4.02 of Revenue Procedure 2020-44 (described below) as covered modifications (not triggering a reissuance or deemed exchange) without regard to the sunset provision of that Revenue Procedure.

- The Final Regulations eliminate the fair market value requirement of the Proposed Regulations that included a substantial equivalence test requiring the contract or debt instrument to have substantially equivalent fair market values before and after the modification, after taking into account one-time payments. In lieu thereof, the Final Regulations substitute a list of modifications that will fail to qualify as covered modifications. Accordingly, any modifications within the scope of these exceptions will need to be analyzed under the general significant modification or Treasury Regulation § 1.1001-1(a) rule, as applicable.

- The Final Regulations permit “associated modifications” to be made to the instrument, without triggering a reissuance or deemed exchange. For this purpose, an associated modification is a modification of the technical, administrative, or operational terms of a contract that is reasonably necessary to adopt or to implement the covered modification (*for example*, a change to the definition of interest period or a change to the timing and frequency of determining rates and making payments of interest). An associated modification includes an incidental cash payment intended to compensate a counterparty for *small* valuation differences resulting from a modification of the administrative terms of a contract, such as the valuation differences resulting from a change in observation period.

- The Final Regulations do not address the character and source of qualified one-time payments (described below), but permit (absent future guidance) taxpayers to rely on the Proposed Regulations, which generally provide that the character and source are the same as they would be for other payments made by such payor under the debt instrument or contract (although the implementation of such rule may not always be clear). Neither the Final Regulations nor the Proposed Regulation address the timing of inclusion of income or deduction of a qualified one-time payment.

- The Final Regulations clarify that a change to the terms of the debt instrument or contract that results from the activation of a fallback rate also must be tested at the time of activation. If the change resulting from the activation of a fallback rate is a covered modification under the Final Regulations, then the special rules provided in the Final Regulations for covered modifications apply to that change. Otherwise, whether that change is a

significant modification or an exchange of property for other property differing materially in kind or in extent is generally determined under the Treasury Regulation § 1.1001-1 or Treasury Regulation § 1.1001-3.

- The Final Regulations provide that a qualified rate may be comprised of more than one fallback rate, such as when the parties add a fallback waterfall. Thus, if the waterfall is designed so that each tier replaces the preceding tier when triggered (for example, when USD LIBOR ceases, USD LIBOR is replaced by the first tier of the waterfall and, if the first tier of the waterfall ceases, that first tier is replaced by the second tier), the entire waterfall is treated as a fallback rate provided each individual fallback rate in the collection meets the requirements to be a qualified rate (or the chance that an applicable fallback rate that would not meet such requirements would actually be implemented, is remote). If it is not possible to determine at the time a modification is being tested as a covered modification whether each non-remote fallback rate in the waterfall qualifies as a qualifying rate (for example, the calculation agent will determine the fallback rate at the time that the fallback rate is triggered based on factors that are not guaranteed to produce a qualifying rate), then the fallback rate (in its entirety) will fail to satisfy the requirements of a qualified rate.

Background

The IRS published final LIBOR (and other IBOR) transition regulations (the "*Final Regulations*") in the Federal Register on January 4, 2022, that are intended to provide special rules to help taxpayers adjust to the discontinuation of certain widely used interest rate benchmarks. These regulations replace the proposed regulations (the "*Proposed Regulations*") that were published on October 9, 2019 with the same objective. On October 9, 2020, subsequent to the issuance of, but prior to the finalization of, the Proposed Regulations, the Treasury Department and the IRS released Revenue Procedure 2020-44 to support the adoption of the Alternative Reference Rates Committee's (the "*ARRC's*") recommended fallback provisions and the ISDA 2020 IBOR Fallbacks Protocol. The ARRC was convened in 2014 by both the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York to support the transition away from USD LIBOR for certain products such as syndicated loans and securitizations, and the ISDA Protocol was developed by the International Swaps and Derivatives Association to permit parties to certain derivative contracts to incorporate particular fallback provisions into the terms of those contracts.

Under Treasury Regulation § 1.1001-3, if a debt instrument is subject to a significant modification (and under Treasury Regulation § 1.1001-1, if a contract other than debt instrument is modified to such an extent that it differs materially in kind or extent from the original contract), the original debt instrument (or contract) may be viewed as exchanged for a new debt instrument (or contract). For taxable instruments this may result in gain or loss, including cancellation of indebtedness income to the borrower. For tax-exempt instruments this may also result in the loss of the exemption for the interest paid thereon.

The Final Regulations generally provide that certain modifications of a debt instrument, derivative, or other contract in anticipation of an elimination of an IBOR referenced in such instrument will not be treated as a significant modification or an exchange of property resulting in gain or loss recognition. They also generally provide that a modification of a contract to replace an IBOR-based rate with a qualified rate is not treated as legging out of a transaction integrated under Treasury Regulation §§1.1275-6, 1.988-5(a), or 1.148-4(h) provided that the components of the transaction continue to qualify for integration after the modification by the end of a 90-day grace period beginning with the first qualified modification of any component of the transaction. In addition, the Final Regulations also generally provide that a modification of a contract to replace an IBOR-based rate with a qualified rate is not treated as a disposition or termination of either leg of a hedging transaction under Treasury Regulation §1.446-4(e)(6). They also generally provide that the modification of a debt or other instrument held by a grantor trust or REMIC (or the modification of a grantor trust certificate or REMIC regular interest) to replace an IBOR-based rate with a qualified rate will not adversely affect the qualification of the issuer as a grantor trust or REMIC.

New Defined Terms

a. Covered modification. A modification that qualifies as a covered modification does not cause a reissuance of the instrument. In very general terms, a "covered modification" is defined as a replacement of a *discontinued IBOR* with a *qualified rate* (or the addition (or substitution of) a fallback rate to eventually replace a discontinued IBOR),

provided that such modification does not include any of several enumerated prohibitions. Transactions described in section 4.02 of Revenue Procedure 2020-44 are treated as covered modifications, apparently without regard as to whether any of the listed prohibitions exist.

b. Qualified rate. A qualified rate is the type of rate that can be used as a replacement rate. It is a "qualified floating rate" as that term is used in certain regulations relating to the accrual of original issue discount (or a fixed multiple thereof even if such multiple is outside the normal parameters of a qualified floating rate). It also includes rates selected, endorsed or recommended by central banks or other analogous authorities (or the ARRC as long as the Federal Reserve Bank of New York is an *ex officio* member of the ARRC at the time of such endorsement). A qualified rate also includes a rate determined by reference to one of the above rates (including a rate determined by adding or subtracting a specified number of basis points to or from the rate or by multiplying the rate by a specified number). A qualified rate also must be based on transactions conducted in the same currency (or otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed finds in the same currency) as the rate it is replacing. In contrast to the Proposed Regulations, the new definition does not require the fair market values of the contract before and after the modification to be substantially equivalent.

c. Qualified one-time payment. Like the Proposed Regulations, the Final Regulations allow a one-time payment to compensate the applicable party for the basis difference between the old and new rate.

d. Discontinued IBOR. A discontinued IBOR generally is an IBOR that is or, based on an official announcement, will be, discontinued. Thus, an IBOR will not be treated as a discontinued IBOR solely because one or more of the *parties* determines that the rate will be discontinued (absent an official announcement). An IBOR ceases to be a discontinued IBOR a year after the IBOR's discontinuation. Accordingly, covered modifications can apply to modifications that occur up to one year after an IBOR has been discontinued and, thus, can be utilized to replace a replacement rate, the adoption of which did not qualify as a covered modification. In addition, the preamble to the Final Regulations (the "*Preamble*") indicates that to the extent the ICE Benchmark Administration publishes synthetic LIBORs after the official rate is discontinued, the one-year period will not commence until after such synthetic LIBORs are no longer published.

General Discussion

The Final Regulations provide special rules to help taxpayers modify their debt instruments or contracts by substituting new IBORs as replacement rates for certain widely held interest rate benchmarks (such as LIBOR) that will eventually be eliminated. These rules permit the taxpayer to substitute a qualified rate for its prior reference rate (or to add or substitute a fallback rate that will be used in the future as a substitute rate). The Final Regulations retain the same requirements as the Proposed Regulations for the type of replacement rates and have not altered the universe of compliant rates. Any fixed multiple (including multiples above 135% and below 65%) of a "qualified floating rate" are again permitted and SOFR (Term or Daily Simple), SIFMA, Prime, Fed Funds, 1-month Treasury, and BSBY all qualify. The Final Regulations also permit the ARRC to identify any other rate as a qualified rate so long as the Federal Reserve Bank of New York is an *ex officio* member of the ARRC at the time of such selection, endorsement, or recommendation.

The Final Regulations also treat modifications described in section 4.02 of Revenue Procedure 2020-44, as may be supplemented by any guidance that may be published in the Internal Revenue Bulletin, as covered modifications. The modifications described in section 4.02 include ISDA Fallback provisions, ARRC Fallback provisions (each as defined in the revenue procedure), or either an ISDA or an ARCC Fallback provision with certain permitted deviations. In addition, a modification described in section 4.02 of Revenue Procedure 2020-44 is treated as a covered modification even if the revenue procedure does not apply to that modification, for example, because the modification occurs after the revenue procedure's sunset date of December 31, 2022. The Preamble indicates that the Final Regulations and the Revenue Procedure are consistent and "no conflict is expected to arise".

The Final Regulations eliminate the substantial equivalence test of the Proposed Regulations, which essentially required (with the aid of a couple of safe harbors) the fair market values of the newly modified instrument and the

pre-modification instrument to be substantially equivalent. The IRS has replaced this test with rules that describe specific modifications that are excluded from the definition of covered modification. Essentially, if the modification possesses any one of the five characteristics, it (or the relevant portion thereof) will not be a covered modification protected by the Final Regulations. In such a case, the modification (or portion thereof) must be tested under the historic analysis under Treasury Regulation § 1.1001-1 and Treasury Regulation § 1.1001-3. The five excluded modifications are:

a. The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is *intended to induce* one or more parties to perform any act necessary to consent to a modification to the contract that would otherwise be a covered modification.

The Final Regulations allow a qualified one-time payment to compensate for the difference between the original rate and the replacement rate, but do not permit an additional payment to induce any party to agree to the change. For example, if the replacement rate is SOFR plus a spread and that spread is calculated to address the expected differences between the two rates, then that change is a covered modification. However, if an additional amount is paid (or deemed paid) to induce a party to accept the modification, that would be problematic under the Final Regulations. The examples in the Final Regulations seem to make it clear that use of spreads published by the ARRC is acceptable, but the modification of any such spread could be interpreted by the IRS as serving as a prohibited inducement. In that case, such modification would need to be tested separately under Treasury Regulation § 1.1001-1 or Treasury Regulation § 1.1001-3. The Final Regulations illustrate this rule by having a borrower offer 10 basis points to each lender as an inducement to agree to a modification that substituted SOFR plus a spread for six-month LIBOR. The spread (absent the 10 extra basis points) was the adjustment spread used or recommended by the International Swaps and Derivatives Association and the Alternative Reference Rates Committee for similar substitutions or replacements. Although the Example states that the10 basis points was an *inducement* (thus making it easy to identify), in practice, it may be extremely difficult to identity an inducement payment that is being paid to all (as opposed to some) of the lenders.

b. The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is *intended to compensate* one or more parties for a modification to the contract not described as a covered modification. This provision should not present significant problems, since if the modification is described as a covered modification, it would not be covered by this limitation. Of course, any other modifications not described as covered modifications should be analyzed separately under either Treasury Regulation § 1.1001-1 or Treasury Regulation § 1.1001-3. If a portion of a modification qualifies as a covered modification but a portion does not, only the portion that does not should be analyzed separately under either Treasury Regulation § 1.1001-1 or Treasury Regulation § 1.1001-3.

c. The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is either a concession granted to a party to the contract because that party is experiencing financial difficulty, or a concession secured by a party to the contract to account for the credit deterioration of another party to the contract. Modifications falling within this exception generally should be readily ascertainable.

d. The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is intended to compensate one or more parties for a change in rights or obligations that are not derived from the contract being modified. Modifications falling within this exception also generally should be readily ascertainable.

e. The terms of the contract are modified to change the amount or timing of contractual cash flows and the modification is identified in guidance published in the Internal Revenue Bulletin as having a principal purpose of achieving a result that is unreasonable in light of the purpose of this section. This is an anti-abuse provision. Language in the Preamble indicates that any such anti-abuse transactions listed in such later guidance (*e.g.*, a revenue ruling or revenue procedure) likely would be prospectively applied.

As indicated above, the Final Regulations allow portions of a modification to be treated as a covered modification while the remaining portion is analyzed separately under Treasury Regulation § 1.1001-1 or Treasury Regulation § 1.1001-3. For example, if the modification included a spread that exceeded the spread allowed under the ARRC language, the additional spread could be analyzed separately and, if it was under 0.25%, that separate modification,

while not considered a covered modification, might nevertheless satisfy the safe harbor under Treasury Regulation §1.1001-3 (the general reissuance rules). In applying Treasury Regulation §1.1001-1(a) or Treasury Regulation §1.1001-3 for this purpose, the covered modification is treated as part of the terms of the contract prior to the noncovered modification. For example, if the parties to a debt instrument modify the interest rate in a manner that is a covered modification and contemporaneously extend the final maturity date of the debt instrument, which is a noncovered modification, only the extension of the final maturity date is analyzed under Treasury Regulation §1.1001-3 and, for purposes of that analysis, the modified interest rate is treated as a term of the instrument prior to the extension of the final maturity date.

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