

INTERNAL REVENUE SERVICE AND TREASURY DEPARTMENT ISSUE FINAL REGULATIONS PROVIDING GUIDANCE ON TRANSITION FROM LIBOR

The U.S. Internal Revenue Service and the Department of Treasury have issued final regulations, available [here](#) (the "Final Regulations"), to provide guidance concerning tax consequences of the transition away from using discontinued tenors of LIBOR or other interbank offered rates ("IBORs") in contracts, such as loans, bonds, asset backed securities and derivatives. The Final Regulations follow the proposed regulations issued on October 9, 2019 and Revenue Procedure 2020-44 published on October 9, 2020. The Final Regulations specify when a modification of a contract or instrument that uses a discontinued IBOR rate will not be considered to constitute a significant modification under U.S. federal income tax law. As described in more detail below, such modifications are referred to as "covered modifications" and other modifications are referred to as "noncovered modifications." The Final Regulations will become effective on March 7, 2022 and, subject to certain conditions, may be relied upon by taxpayers in connection with any instruments or contracts modified before the effective date.

GENERAL RULE

Under § 1.1001-6(b)(1) of the Final Regulations, a "covered modification" of a contract is not treated as an exchange of property for other property differing materially in kind or in extent for purposes of § 1.1001-1(a) of the Treasury Regulations. Accordingly, any "covered modification" would not require parties to recognize gain or loss as a result of the modification.

Discontinued IBORs. To be considered in-scope for purposes of the Final Regulations, the contract or instrument to be modified must have an operative rate or fallback provision that references a discontinued IBOR. A discontinued IBOR is

generally an IBOR that has been or will be discontinued, except that a rate will cease to be a "discontinued IBOR" one year after its publication has permanently or indefinitely ceased. As formally announced by ICE Benchmark Administration ("IBA") on March 5, 2021, LIBOR is no longer being published for Sterling, Euro, Swiss Franc and Japanese Yen LIBOR settings in all tenors, and the 1-week and 2-month tenors of U.S. Dollar LIBOR. At that time, the IBA also announced its intention to no longer publish U.S. Dollar LIBOR for overnight, 1-month, 3-month, 6-month and 12-month tenors after June 30, 2023. The IBA is continuing to publish synthetic GBP LIBOR and synthetic JPY LIBOR for a limited time and may publish synthetic U.S. Dollar LIBOR for a limited time after June 30, 2023. For purposes of the Final Regulations, these synthetic LIBORs are deemed to be a continuation of the currency and tenor variant of LIBOR that they succeed.

COVERED MODIFICATIONS

Any modification of a contract or instrument is a "covered modification" for purposes of the Final Regulations if it:

- replaces an operative rate that refers to a discontinued IBOR with a qualified rate and, if the parties so choose, a one-time payment;
- includes a qualified rate as one of several fallback rates to replace a discontinued IBOR rate; or
- replaces a single fallback rate that refers to a discontinued IBOR with a qualified rate.

In addition, any modifications associated with covered modifications to the operative rate or fallback provisions that is reasonably necessary to adopt or to implement that replacement or inclusion would also constitute a "covered modification." Any changes in the spread added to the reference rate (often referred to as a "spread adjustment") must be limited to a percentage that solely compensates lenders for the difference between the discontinued IBOR and the replacement reference rate.

Further, any one-time payment will only be treated as a covered modification if it relates to a change to an operative rate. If any one-time payment is made in connection with a change to fallback rates, this would be considered a non-covered modification. As with a spread adjustment, any one-time payment must be limited to an amount that solely compensates lenders for the difference between the discontinued IBOR and the replacement reference rate.

For the avoidance of doubt, the ISDA Fallback and ARRC Fallback language covered by Rev. Proc. 2020-44 will qualify as covered modifications for purposes of the Final Regulations.

Qualified rate. To constitute a covered modification, the reference rate replacing an operative rate that refers to a discontinued IBOR or that is included as a fallback rate that would replace a discontinued IBOR must be a "qualified rate." As defined in the Final Regulations, this includes any rate that is reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency as the discontinued IBOR. Examples include SOFR, the Sterling Overnight Index Average, the Tokyo Overnight Average Rate, the Swiss Average Rate Overnight, and the euro short-term rate administered by the

European Central Bank. Rates selected, endorsed or recommended by a central bank, reserve bank, monetary authority or similar institution as a replacement for the discontinued IBOR or its local currency equivalent in that jurisdiction will also be "qualified rates."

NONCOVERED MODIFICATIONS

Any modifications that do not qualify as covered modifications are outside the scope of the Final Regulations and would be treated as noncovered modifications. The Final Regulations define "noncovered modifications" to include the following:

- the amount or timing of contractual cash flows are changed to induce one or more parties to consent to a modification to the contract;
- the amount or timing of contractual cash flows are changed to compensate one or more parties for a modification to the contract that is not a covered modification;
- the amount or timing of contractual cash flows are changed either as 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;
- the amount or timing of contractual cash flows are changed to compensate one or more parties for a change in rights or obligations unrelated to the contract being modified; or
- the amount or timing of contractual cash flows are modified in a manner identified by the IRS in published guidance as having a principal purpose of achieving a result that is unreasonable.

If a noncovered modification is made to a contract or instrument contemporaneous with covered modifications, for purposes of analyzing whether the noncovered modification results in an exchange of property that is treated as a significant modification of the contract or instrument for U.S. federal income tax purposes, the covered modifications are treated as part of the instrument prior to the noncovered modifications.

IMPACT ON CERTAIN INSTRUMENTS

Integrated transactions and qualified hedges. A covered modification of one or more contracts that are part of an integrated transaction or of a contract that is a qualified hedge generally does not change the treatment of the integrated transaction or qualified hedge as long as each leg of the integrated transaction or the qualified hedge is modified within 90 days of the first covered modification and the financial instrument or combination of financial instruments that result from the covered modifications satisfy the requirements to be treated as an integrated transaction or a qualified hedge. Further, an interim hedge could also be entered into without disrupting the treatment of a transaction.

FATCA. A covered modification is not a material modification of that contract for purposes of determining whether an instrument is grandfathered for purposes of its FATCA treatment.

Fast-pay stock. A covered modification is not a significant change for purposes of the fast-pay stock rules, but if covered and noncovered modifications are made at the same time all changes will be considered for purposes of determining whether the stock has become fast-pay stock.

Investment Trusts and REMICs. A covered modification does not give an investment trust a power to vary the investment that would cause it to fail as a grantor trust. Special rules apply to real estate mortgage investment conduits ("REMICs"). Covered modifications to the rates on REMIC regular interests generally will not cause a REMIC to fail to qualify as a REMIC and covered modifications to the rates on the mortgage loans a REMIC holds generally will not cause those mortgage loans to cease to qualify as qualified mortgage loans for purposes of the REMIC provisions. However, any changes to the spread on such REMIC regular interests or the spread on mortgage loans must be limited solely adjust for differences between the discontinued IBOR and the new reference interest rate. Additional changes would be outside these rules.

CONCLUSION

The Final Regulations address the concern that modification of contractual terms to replace a discontinued IBOR with a new reference rate could result in adverse tax consequences. They generally provide that a modification of a contract or instrument to replace a discontinued IBOR with a new qualified rate will not be a taxable event. The Final Regulations will become effective on March 7, 2022 and, subject to certain conditions, may be relied upon by taxpayers in connection with any instruments or contracts modified before the effective date.

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