

MEMO# 32002

October 10, 2019

IRS Issues Guidance on Transition from IBOR to Other Reference Rates

[32002]

October 10, 2019 TO: ICI Members

Tax Committee SUBJECTS: Tax RE: IRS Issues Guidance on Transition from IBOR to Other Reference Rates

The Treasury Department and the Internal Revenue Service (IRS) have issued [proposed regulations](#) addressing tax issues arising from the transition from an interbank offered rate (IBOR) to other reference rates in debt instruments and non-debt contracts. The guidance clarifies whether changes to the terms of a debt instrument or other type of contract to replace an IBOR with another reference rate results in the realization of income, deduction, gain, or loss, or other income tax consequences.[\[1\]](#) The government hopes that clarification of these issues will minimize potential market disruption and facilitate an orderly transition from IBORs to other reference rates, thus reducing taxpayer burdens.

Changes to the Terms of a Debt Instrument or Non-Debt Contract

The proposed regulations generally provide that changes to the terms of a debt instrument to replace an IBOR with certain “qualified rates” (as defined in the proposed regulations) and any “associated alteration” are not treated as modifications of the debt instrument and therefore do not result in an exchange of the debt instrument for federal income tax purposes.[\[2\]](#) The same rule would apply to non-debt contracts, such as derivatives, stocks, insurance contracts and lease agreements.[\[3\]](#) Further, a change to the terms of a debt instrument or non-debt contract to include a qualified rate as a fallback rate to an IBOR-referencing rate and any associated alteration would not be treated as a modification of the debt instrument or non-debt contract and thus would not result in an exchange of the debt instrument.[\[4\]](#)

An “associated alteration” is any change to the terms of a debt instrument or non-debt contract that is associated with the replacement of a qualified rate for, or inclusion as a fallback to, the IBOR-referencing rate; the associated alteration must be reasonably necessary to adopt or implement that replacement or inclusion.[\[5\]](#) This could include, for example, changes to the definition of interest period or changes to the timing and frequency of determining rates and making interest payments. It also could include the addition of an obligation for one party to make a one-time payment in connection with the replacement of the IBOR-referencing rate to offset the change in value of the debt instrument or non-debt contract resulting from that replacement.

If other alterations or modifications are made to the terms of a debt instrument or a non-debt contract at the same time as any changes are made to replace the IBOR, the existing rules in the regulations under section 1001 apply to determine whether such contemporaneous alterations or modifications result in an exchange of the debt instrument or the non-debt contract.[\[6\]](#)

Qualified Rates

The proposed regulations include a list of rates that would be treated as a “qualified rate” for purposes of these rules.[\[7\]](#) In general, a qualified rate is any qualified floating rate as defined in Treas. Reg. § 1.1275-5(b) (including multiples of a qualified floating rate). To avoid any uncertainty, the proposed regulations list several such rates that have been selected by a central bank, reserve bank, monetary authority, or similar institution as a replacement for an IBOR or its local currency equivalent in that jurisdiction, including the Secured Overnight Financing Rate published by the Federal Reserve Bank of New York (SOFR). A qualified rate also would include any rate that is determined by reference to one of these rates (e.g., a rate determined by adding or subtracting a certain number of basis points to or from the rate). The proposed regulations give the IRS the authority to identify additional rates as qualified rates.

A rate is a qualified rate for purposes of the proposed regulations only if the fair market value of the debt instrument or non-debt contract after the alteration or modification is substantially equivalent to the fair market value of the instrument or contract before the alteration or modification.[\[8\]](#) To determine the fair market value, the parties would be permitted to use any reasonable, consistently applied valuation method, taking into account the value of any one-time payment made in connection with the alteration or modification. A reasonable valuation method could be based in whole or in part on past or projected values of the relevant rate, though this is not required.

The proposed regulations provide two safe harbors that could be used to satisfy the fair market value requirement:[\[9\]](#)

1. The fair market value requirement would be deemed satisfied 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 made in connection with the alteration or modification.
2. Alternatively, the fair market value requirement would be deemed satisfied if the parties to the debt instrument or non-debt contract are not related, and the parties determine, based on bona fide, arm’s length negotiations, that the fair market value of the debt instrument or non-debt contract before the alteration or modification is substantially equivalent to the fair market value after the alteration or modification (taking into account any one-time payment).

The proposed regulations give the IRS the authority to set forth additional circumstances in which a rate is treated as satisfying these requirements.

A rate would be a qualified rate only if the interest rate benchmark to which the rate refers after the alteration or modification and the IBOR to which the debt instrument or non-debt contract referred before the alteration or modification are based on transactions conducted in the same currency or otherwise are reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency.[\[10\]](#)

Effect on Integrated Transactions and Hedges

The proposed regulations clarify that a change to the terms of a debt instrument or a derivative to replace an IBOR-referencing rate with a qualified rate on one or more legs of a transaction that is integrated under Treas. Reg. § 1.988-5 or § 1.1275-6 is not treated as legging out of the transaction, so long as the hedge as modified continues to meet the applicable requirements.[\[11\]](#) Similarly, a change to the terms of a debt instrument or derivative to replace an IBOR-referencing rate with a qualified rate on one or more legs of a transaction that is subject to the hedge accounting rules (as described in Treas. Reg. § 1.446-4) would not be treated as a disposition or termination of either leg of the transaction.[\[12\]](#) Further, replacing an IBOR-referencing rate with a qualified rate on a hedging transaction for bonds that is integrated as a qualified hedge for purposes of the arbitrage investment restrictions applicable to State and local tax-exempt bonds and other tax-advantaged bonds would not be treated as a termination of that qualified hedge, provided that the hedge as modified continues to meet the requirements under Treas. Reg. § 1.148-4(h).[\[13\]](#)

One-Time Payments

The proposed regulations provide that the source and character of a one-time payment that is made by a payor in connection with the alteration or modification of a debt instrument or non-debt contract is the same as the source and character that otherwise would apply to a payment made by the payor with respect to the altered or modified debt instrument or non-debt contract.[\[14\]](#) Because the IRS and the Treasury Department expect that one-time payments generally will be paid by the borrower to the lender (to reflect the differences in term and credit risk between an IBOR and the nearly risk-free rate that replaces it), the proposed regulations do not address one-time payments received by the payor. If such guidance is needed, however, the government requests comments on the source and character of a one-time payment received by a party that does not ordinarily receive payments during the term of the debt instrument or non-debt contract (e.g., the borrower on a debt instrument or the lessee on a lease).

Other Provisions

Grandfathered Debt Instruments and Non-Debt Contracts. The proposed regulations clarify that debt instruments and non-debt contracts that are grandfathered under certain rules in the Internal Revenue Code, such as sections 163(f), 871(m), or 1471, would not lose their grandfathered status as a result of any alterations or modifications made in connection with the elimination of IBOR as described in the proposed regulations.[\[15\]](#)

OID and VRDI. The proposed regulations include three rules regarding the amount and accrual of original issue discount (OID) in the case of a variable rate debt instrument (VRDI) that provides both for interest at an IBOR-referencing qualified floating rate and for a fallback rate that is triggered when the IBOR becomes unavailable or unreliable. First, the IBOR-referencing qualified floating rate and the fallback rate would be treated as a single qualified floating rate for purposes of Treas. Reg. § 1.1275-5.[\[16\]](#) Second, the possibility that the relevant IBOR will become unavailable or unreliable would be treated as a remote contingency for purposes of Treas. Reg. § 1.1275-2(h).[\[17\]](#) Finally, the occurrence of the event that triggers activation of the fallback rate would not be treated as a change in circumstances.[\[18\]](#)

REMICs. The proposed regulations provide special rules clarifying that an interest in a real estate mortgage investment conduit (REMIC) does not lose its status as a regular interest because of any alterations or contingencies that replace an IBOR-referencing rate with a

qualified rate, or that include a qualified rate as a fallback to an IBOR-referencing rate.[\[19\]](#)

Interest Expense of a Foreign Corporation. The proposed regulations amend the election in Treas. Reg. § 1.882-5(d)(5)(ii) to allow a foreign corporation that is a bank to compute interest expense attributable to excess US-connected liabilities using a yearly average SOFR. Because the election currently only permits a bank to elect a rate that references the 30-day London Interbank Offered Bank (LIBOR), the election otherwise would become unavailable once LIBOR is phased out.

Effective Date

The proposed regulations generally will be effective for modifications and alterations that occur after the date of publication of final regulations in the Federal Register. Taxpayers, however, may rely on the proposed regulations before the publication of final regulations, provided that taxpayers and any related parties apply the proposed regulations consistently.

Request for Comments

The IRS and Treasury Department have asked for comments on the proposed regulations or requests for a public hearing by November 25, 2019.

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endnotes

[\[1\]](#) In general, the regulations under section 1001 provide that a “significant modification” of a debt instrument results in treatment as an exchange of the original debt instrument for the modified debt instrument, triggering the realization of gain or loss for federal income tax purposes.

[\[2\]](#) Prop. Reg. § 1.1001-6(a)(1).

[\[3\]](#) Prop. Reg. § 1.1001-6(a)(2).

[\[4\]](#) Prop. Reg. § 1.1001-6(a)(3).

[\[5\]](#) Prop. Reg. § 1.1001-6(a)(5).

[\[6\]](#) Prop. Reg. § 1.1001-16(a)(4).

[\[7\]](#) Prop. Reg. § 1.1001-6(b)(1).

[\[8\]](#) Prop. Reg. § 1.1001-6(b)(2)(i).

[\[9\]](#) Prop. Reg. § 1.1001-6(b)(2)(ii).

[\[10\]](#) Prop. Reg. § 1.1001-6(b)(3).

[\[11\]](#) Prop. Reg. § 1.1001-6(c).

[12] *Id.*

[13] *Id.*

[14] Prop. Reg. § 1.1001-6(d).

[15] Prop. Reg. § 1.1001-6(e).

[16] Prop. Reg. § 1.1275-2(m)(2).

[17] Prop. Reg. § 1.1275-2(m)(3).

[18] Prop. Reg. § 1.1275-2(m)(4).

[19] Prop. Reg. § 1.180G-1(e).

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