

**MEMO# 34003**

January 18, 2022

# Treasury and IRS Issue Final Regulations on IBOR Transition

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TO: ICI Members  
ICI Global Members  
Global Tax Committee  
LIBOR Transition Working Group  
Tax Committee SUBJECTS: Tax RE: Treasury and IRS Issue Final Regulations on IBOR Transition

The Treasury Department and the Internal Revenue Service (IRS) have issued [final regulations](#) regarding the transition from the London Interbank Offered Rate (LIBOR) and other Interbank Offered Rates (IBORs) to an alternative reference rate. The final regulations are consistent with the proposed regulations that were released in 2019<sup>[1]</sup> but make several changes intended to simplify and streamline the rules.

## Changes to the Terms of a Contract

The final regulations, like the proposed regulations, provide that "covered modifications" to the terms of a contract to replace LIBOR or another IBOR will not be treated as an exchange of property for federal income tax purposes.<sup>[2]</sup> A contract for this purpose includes, but is not limited to, a debt instrument, a derivative contract, stock, an insurance contract, and a lease agreement.

Notably, the final regulations eliminate the proposed fair market value requirement, replacing it with rules that exclude certain specific modifications from the definition of "covered modification."

## Covered Modification

A "covered modification" is defined as a modification or portion of a modification of the terms of a contract to:

- i. Replace an operative rate that references a discontinued IBOR with a qualified rate (as defined in the regulations), to add an obligation for one party to make a qualified one-time payment (if any), and to make associated modifications (if any);

- ii. Include a qualified rate as a fallback to an operative rate that references a discontinued IBOR and to make associated modifications (if any); and
- iii. Replace a fallback rate that references a discontinued IBOR with a qualified rate and to make associated modifications (if any).[\[3\]](#)

Any modification of the terms of a contract described in section 4.02 of Revenue Procedure 2020-44,[\[4\]](#) or described in other IRS guidance updating the revenue procedure, is treated as a covered modification.[\[5\]](#)

As mentioned above, the final regulations do not include a fair market value requirement, as originally proposed, to determine whether a modification is a covered modification.

### ***Qualified Rate***

In general, a "qualified rate" is defined as:

- i. A qualified floating rate generally as defined in Treas. Reg. § 1.1275-5(b) (examples include the Secured Overnight Financing Rate (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);
- ii. An alternative, substitute, or successor rate selected, endorsed, or recommended by the central bank, reserve bank, monetary authority, or similar institution (including any committee or working group thereof) as a replacement for a discontinued IBOR or its local currency equivalent in that jurisdiction;
- iii. A rate selected, endorsed, or recommended by the Alternative Reference Rates Committee (ARRC) as a replacement for USD LIBOR, provided that the Federal Reserve Bank of New York is an ex officio member of the ARRC at the time of the selection, endorsement, or recommendation;
- iv. A rate that is determined by reference to a qualified rate described above, 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; and
- v. A rate identified for purposes of these regulations as a qualified rate by the IRS.[\[6\]](#)

A rate described above will be a qualified rate provided that the interest rate benchmark to which the rate refers and the discontinued IBOR 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.[\[7\]](#)

A single qualified rate may be comprised of one or more fallback rates. If, however, the rate being tested is comprised of more than one fallback rate, the rate is a qualified rate only if each individual fallback rate separately satisfies the requirements to be a qualified rate.[\[8\]](#) If it is not possible to determine at the time of the modification whether a fallback rate is a qualified rate, that fallback rate is not treated as satisfying the requirements to be a qualified rate.[\[9\]](#) A fallback rate is treated as a qualified rate if the likelihood is remote that any value will ever be determined under the contract by reference to the fallback rate.[\[10\]](#) The final regulations include several examples demonstrating application of the fallback rate rules.[\[11\]](#)

### ***Discontinued IBOR***

An interbank offered rate is a discontinued IBOR if the administrator of the rate announces that the administrator has ceased or will cease to provide the rate permanently or indefinitely, and no successor administrator is expected to continue to provide such

rate.<sup>[12]</sup> An interbank offered rate also is a discontinued IBOR if the regulatory supervisor for the administrator of the rate, the central bank for the currency of the rate, an insolvency official with jurisdiction over the administrator, a resolution authority with jurisdiction over the administrator, a court, or an entity with similar insolvency or resolution authority over the administrator announces that the administrator has ceased or will cease to provide the interbank offered rate permanently or indefinitely, and no successor administrator is expected to provide the interbank offered rate.<sup>[13]</sup>

A rate is a discontinued IBOR only during the period beginning on the date of the announcement described above and ending on the date that is one year after the date on which the administrator of the interbank offered rate ceases to provide the rate.<sup>[14]</sup>

### ***Associated Modification***

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 a covered modification. It also 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.<sup>[15]</sup> For example, changing the definition of interest period or the timing and frequency of determining rates and making payments of interest are associated modifications.

### ***Qualified One-Time Payment***

A qualified one-time payment is a single cash payment intended to compensate the other party or parties for all or part of the basis difference between the discontinued IBOR and the interest rate benchmark to which the qualified rate refers.<sup>[16]</sup>

The proposed regulations generally provide that the character and source of a one-time payment is the same as the source and character of a payment under the contract by that payor. The Treasury and IRS received several comments asking for clarification of these rules. The final regulations do not address this issue, as the government continues to consider how best to address the character and timing of qualified one-time payments. Until they provide further guidance, the Preamble to the final regulations provides that taxpayers may continue to rely on the rule in § 1.1001-6(d) of the Proposed Regulations.

### ***Noncovered Modifications***

Certain modifications do not qualify as "covered modifications" and thus are "noncovered modifications." A modification is a noncovered modification if the terms of the contract are modified to change the amount or timing of contractual cash flows and such change is intended to (i) induce one or more parties to perform any act necessary to consent to a covered modification; (ii) compensate one or more parties for a modification that is not a covered modification; (iii) grant a concession 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; (iv) compensate one or more parties for a change in rights or obligations that are not derived from the contract being modified; or (v) have the principal purpose of achieving a result that is unreasonable in light of the purposes of these rules, as set forth in guidance by the IRS.<sup>[17]</sup>

### ***Contemporaneous Covered and Noncovered Modifications***

If a covered modification is made at the same time as a noncovered modification, the rules

under Treas. Reg. § 1.1001-1(a) or § 1.1001-3, as appropriate, apply to determine whether the noncovered modification results in the exchange of property for federal income tax purposes.[\[18\]](#) In applying these rules, the covered modification is treated as part of the terms of the contract prior to the noncovered modification.

### Effect on Integrated Transactions and Hedges

As provided in the proposed regulations, the final regulations generally provide that a covered modification of one or more contracts 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.[\[19\]](#) Similarly, a covered modification to one or more legs of a transaction that is subject to the hedge accounting rules (as described in Treas. Reg. § 1.446-4) is not treated as a disposition or termination of either leg of the transaction.[\[20\]](#) Further, replacing a covered transaction to 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 is not 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).[\[21\]](#)

In response to comments on the proposed regulations, the final regulations provide a grace period during which a covered modification of a component of an integrated transaction under Treas. Sec. § 1.1275-6, § 1.988-5(a), or § 1.148-4(h) does not result in legging out of that integrated transaction even though there may be a mismatch in timing or amount of payments resulting from the covered modification during that period. The grace period is the 90-day period beginning on the date of the first covered modification of any component of the integrated transaction. Further, if a taxpayer enters into a financial instrument to mitigate such temporary mismatches during the grace period, the interim hedge is not treated as disrupting a transaction integrated under Treas. Reg. § 1.1275-6 or § 1.988-5(a).

### Other Provisions

**Fast Pay Stock.** The final regulations provide that a covered modification of stock is not a significant modification to the terms of the stock or the related agreements, or a significant change in the relevant facts and circumstances, for purposes of determining whether stock is fast-pay stock under Treas. Reg. § 1.7701-3(b)(2)(ii).[\[22\]](#) If, however, a covered modification and a noncovered modification are made contemporaneously and the noncovered modification is a significant modification or change, then the rules in Treas. Reg. § 1.7701-3(b)(2)(ii) will apply, and all the facts and circumstances (including the covered modification) will be considered to determine whether the stock is fast-pay stock.

**Investment Trusts.** An investment trust under Treas. Reg. § 301.7701-4(c)(1) is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. The final regulations clarify that a covered modification of a contract held by an investment trust or of an ownership interest in an investment trust does not manifest a power to vary the investment of the certificate holders.[\[23\]](#)

**Interest Expense of a Foreign Corporation.** The proposed regulations would have amended 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. The Treasury Department and the IRS continue to study the appropriate rate to replace 30-day USD LIBOR for purposes of this election. In the meantime, taxpayers may continue to apply either the general rule or the annual published rate election

provided under Treas. Reg. § 1.1882-5(d)(5)(ii) to calculate interest on excess U.S.-connected liabilities. Taxpayers also may continue to rely on the rule in the proposed regulations.

#### Effective Date

The final regulations are applicable to a modification of the terms of a contract that occurs on or after March 7, 2022. A taxpayer may choose to apply the rules in the final regulations to modifications of the terms of contracts that occur before March 7, provided that the taxpayer and all related parties apply these rules to all modifications of the terms of contracts that occur before that date.[\[24\]](#)

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#### endnotes

[\[1\]](#) See [Institute Memorandum No. 32002](#), dated October 10, 2019.

[\[2\]](#) Treas. Reg. § 1.1001-6(b).

[\[3\]](#) Treas. Reg. § 1.1001-6(h)(1).

[\[4\]](#) See [Institute Memorandum No. 32830](#), dated October 14, 2020. Revenue Procedure 2020-44 clarifies that certain modifications to contracts adopting fallback language recommended by the Alternative Reference Rates Committee (ARRC) or the International Swaps and Derivatives Association (ISDA) will not be treated as a material exchange of property for purposes of Treas. Reg. § 1.1001-1(a).

[\[5\]](#) Treas. Reg. § 1.1001-6(h)(1).

[\[6\]](#) Treas. Reg. § 1.1001-6(h)(3)(ii).

[\[7\]](#) Treas. Reg. § 1.1001-6(h)(3)(i).

[\[8\]](#) Treas. Reg. § 1.1001-6(h)(3)(iii).

[\[9\]](#) Treas. Reg. § 1.1001-6(h)(3)(iii)(B).

[\[10\]](#) Treas. Reg. § 1.1001-6(h)(3)(iii)(C).

[\[11\]](#) Treas. Reg. § 1.1001-6(h)(3)(iv).

[\[12\]](#) Treas. Reg. § 1.1001-6(h)(4)(i).

[\[13\]](#) Treas. Reg. § 1.1001-6(h)(4)(ii).

[\[14\]](#) Treas. Reg. § 1.1001-6(h)(4).

[\[15\]](#) Treas. Reg. § 1.1001-6(h)(5).

[\[16\]](#) Treas. Reg. § 1.1001-6(h)(6).

[\[17\]](#) Treas. Reg. § 1.1001-6(j).

[\[18\]](#) Treas. Reg. § 1.1001-6(b)(2).

[\[19\]](#) Treas. Reg. § 1.1001-6(c)(i) and (ii).

[\[20\]](#) Treas. Reg. § 1.1001-6(c)(iii).

[\[21\]](#) Treas. Reg. § 1.1001-6(c)(iv).

[\[22\]](#) Treas. Reg. § 1.1001-6(e).

[\[23\]](#) Treas. Reg. § 1.1001-6(f).

[\[24\]](#) Treas. Reg. § 1.1001-6(k).

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