Reminder: Tax Consideration for LIBOR Transition

As the June 30, 2023 sunset for the remaining U.S. Dollar (USD) London Interbank Offered Rate (LIBOR) tenors approaches, keep in mind important tax considerations. Earlier this year, the IRS finalized LIBOR transition regulations that allow modifications of debt instruments and other contracts to replace LIBOR without triggering a reissuance or deemed exchange if certain conditions are met. The rules were effective on March 7, 2022.

Background

Under U.S. Department of the Treasury (Treasury) Regulation Section 1.1001, if a debt instrument is subject to a significant modification, 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 also may result in the loss of the exemption for the interest paid thereon.

The IRS recognized that LIBOR modifications of a debt instrument or hedging agreement could result in a realized gain or loss and income or deductions for federal income tax purposes. In October 2019, Treasury and the IRS released proposed regulations that closely followed recommendations from the U.S. transition working group, Alternative Reference Rates Committee (ARRC). However, due to the COVID-19 pandemic, finalization of the regulations was delayed. On October 9, 2020, Treasury released Revenue Procedure (Rev. Proc.) 2020-44 in advance of a final rule that provided that certain LIBOR modifications would not be treated as an exchange of property for other property differing materially in kind or extent for purposes of §1.1001 or that LIBOR-related hedge modifications would not result in the termination of a hedging transaction.

The final rules are substantially similar but more comprehensive than the proposal based on feedback received.

Available Tax Relief

Final Treasury Regulation §1.1001-6 (LIBOR Regulations) provides more comprehensive guidelines to modifications of agreements without being deemed to be significant modifications. The LIBOR Regulations provide that a covered modification of an agreement will not result in a significant modification, and for tax-exempt bonds and interest rate hedges, a covered modification of either would not result in a reissuance or deemed termination of either, respectively, for federal income tax purposes.

A covered modification includes any modification to:

- Replace an operative rate that references a "discontinued IBOR (interbank offered rate)" with a "qualified rate"
- Add an obligation for one party to make a qualified one-time payment. A qualified one-time payment is capped at the amount to compensate for the basis difference between the discontinued IBOR and the new rate. An amount over the cap is a noncovered modification
- Include a "qualified fallback rate" to an operative rate that references a discontinued IBOR
- Make "associated modifications" in connection with any of the above-mentioned modifications
- Incorporate permissible fallback language as described in Rev. Proc. 2020-44 replacing a rate referencing an IBOR with a qualified rate

The guidance applies regardless of whether the modification occurs by amendment to an existing contract or an exchange of the new contract for old.

Qualified Rate

A qualified rate includes any of the following, provided that the interest rate benchmark and the discontinued IBOR are based on transactions conducted in the same currency or are otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency:

- A qualified floating rate as defined in Treasury Regulation §1.1275-5(b) but without regard to the limitations on the 0.65 to 1.35 multiples, *e.g.*, Secured Overnight Financing Rate (SOFR)
- 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
- A rate selected, endorsed, or recommended by the ARRC as a USD LIBOR replacement, 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
- A rate that is determined by reference to any of the three above-mentioned 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 rate identified as a qualified rate in guidance published in Rev. Proc. 2020-44

The interest rate benchmark and the discontinued IBOR must be in the same currency or are otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency.

Multiple Fallback Rates

If the modifications include adding multiple fallback rates, *i.e.*, a waterfall, the LIBOR Regulations provide that the rate being tested is a qualified rate only if each individual fallback rate separately satisfies the requirements to be a qualified rate. Unless the likelihood of a fallback rate is remote, if such fallback rate cannot be determined at the time of the modification to satisfy the requirements for a qualified rate, then such a fallback rate is not treated as a qualified rate and the waterfall of rates will not be considered to be a qualified fallback rate. The LIBOR Regulations included three detailed examples.

Noncovered Modifications

A noncovered modification is any modification that is not a covered modification and would need to be tested under the existing reissuance rules in §1.1001-1 to 3. If modifications include both covered modifications and noncovered modifications, the covered modification is treated as part of the terms of the contract prior to the noncovered modification. Some examples of noncovered modifications include changes to the amount or timing of contractual cash flows:

- To induce one or more parties to perform any act necessary to consent to a covered modification
- To compensate one or more parties for a noncovered modification
- To either grant a concession granted to a party to the contract because that party is experiencing financial difficulty or secure a concession to account for the credit deterioration of another party to the contract
- To compensate one or more parties for a change in rights or obligations that are not derived from the contract being modified in a covered modification

- Otherwise identified in the Internal Revenue Bulletin as having a principal purpose of achieving a result that is unreasonable considering the purpose of the LIBOR Regulations

Banks and other counterparties frequently require a consent fee for a modification—these consent fees are excluded from the definition of covered modification.

Example

If the parties to a debt instrument modify the interest rate to reflect LIBOR cessation and contemporaneously extend the debt's final maturity date, which is a noncovered modification, only the extension of the final maturity date is analyzed under §1.1001–3 and the modified interest rate is treated as a term of the instrument prior to the extension of the final maturity date.

Qualified Hedges & Integrated Transactions

A covered modification of a qualified hedge that was integrated with an issue of tax-exempt bonds is not treated as terminated, provided that, no later than 90 days after the date of the first covered modification of either the qualified hedge or the hedged bonds, the now-modified qualified hedge satisfies the special rules under Treasury Regulation §1.148–4(h)(3)(iv)(C) for retesting the qualified hedge with respect to the hedged bonds that result from any such covered modification. Any qualified one-time payment with respect to the hedge or the hedged bonds (or both) is allocated in a manner consistent with the allocation of a termination payment for a variable yield issue and treated as a series of periodic payments.

REMICs – §1.860G1-1

An interest in a real estate mortgage investment conduit (REMIC) would generally be able to retain its status as a regular interest for modifications related to transition from LIBOR. The final rule clarifies that an interest in a REMIC does not fail to qualify as a regular interest solely because it is subject to a contingency if the REMIC's principal or interest payment is reduced by reasonable costs related to a covered LIBOR modification. Payment of reasonable LIBOR modification costs by a party other than the REMIC is not a contribution to the REMIC.

Change in Accounting Method

Treasury and the IRS will not treat a change from a discount rate that is based on a discontinued IBOR to a discount rate that is a qualified rate for the purpose of valuing securities under the mark-to-market rules in §475 as a change in method of accounting under §446(e), which means that no consent is required.

Effective Dates

The final regulations apply to modifications that occur on or after March 7, 2022. A taxpayer may choose to apply the final regulations to modifications occurring prior to March 7, 2022, provided that the taxpayer and all related parties apply the final regulations to all modifications of contract terms that occur before that date.

Conclusion

By taking steps to identify and mitigate risks early, institutions will be better prepared to address potential risks that may arise from the LIBOR transition. The transition away from LIBOR will be complicated and likely will require significant hours to implement correctly for companies with a large volume of contracts. For more information, visit **forvis.com**.

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