

IRS Issues Final Regulations on Transition from IBORs to Other Reference Rates

By [Eugene G. Bernardo II](#) and [David M. DiSegna](#)

The IRS has issued final regulations governing the tax consequences of transitions from Interbank Offered Rates (IBORs) to other reference rates in debt instruments. The final regulations adopt many of the proposed regulations that the IRS released on October 9, 2020, with some important changes. The regulations provide important guidance for bond issuers whose tax-exempt bonds could be treated as reissued—potentially triggering adverse tax consequences—if changes to the bonds are made to transition from an IBOR to a replacement or fallback reference rate.

Covered Modifications

Under the regulations, a “covered modification” of a debt instrument is not treated as a significant modification for purposes of Treasury Regulations § 1.1001-3, and therefore will not trigger a reissuance of the debt instrument. A covered modification is defined as a modification or a portion of a modification whereby the terms of the contract are modified to:

- (i) replace an operative rate that references a discontinued IBOR with a qualified rate, 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); or
- (iii) replace a fallback rate that references a discontinued IBOR with a qualified rate and to make associated modifications (if any).

Discontinued IBOR

A discontinued IBOR is any IBOR the administrator or a regulator of which has announced that the administrator has ceased or will cease to provide the IBOR permanently or indefinitely, and no successor administrator is expected as of the time of the announcement to continue to provide the IBOR. Significantly, any such IBOR is only a “discontinued IBOR” from the date of the announcement until one year after the administrator ceases to provide such IBOR.

Qualified Rate

A qualified rate is defined in the regulations as one of the following:

- (i) A qualified floating rate, as defined in Treasury Regulation § 1.1275-5(b), but without regard to the limitations on multiples set forth therein;
- (ii) A rate selected by certain regulatory bodies as a replacement for a discontinued IBOR in their jurisdictions;
- (iii) A rate selected 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;

(iv) A rate that is determined by reference to a rate described in (i), (ii), or (iii) 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 as a qualified rate in guidance published in the Internal Revenue Bulletin.

Additionally, the qualified rate and the discontinued IBOR must be 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. Moreover, if 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 set forth above. If, at the time of the modification, it is not possible to determine whether the fallback rate is a qualified rate (for example, if a lender is to determine the rate based on industry standards at the time the IBOR rate is discontinued), then the fallback rate is not treated as a qualified rate, unless the likelihood that any value will ever be determined by reference to such fallback rate is remote.

Associated Modifications and Qualified One-time Payments

Under the regulations, 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 modifications, including, 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. Additionally, when replacing a discontinued IBOR, the regulations permit a “qualified one-time payment” which is defined as a single cash payment that is intended to compensate a party for all or part of the basis difference between the discontinued IBOR and the interest rate benchmark to which the qualified rate refers. The IRS is still considering how a qualified one-time payment is to be treated for arbitrage and private use purposes in the case of tax-advantaged bonds. Until further guidance is provided, however, parties may rely on the proposed regulations, which merely state that the character and source of a one-time payment made by a given payor is the same as the source and character of a payment under the contract by that payor.

Exclusions

Importantly, unlike the proposed regulations, there is no requirement that the fair market value of the contract be substantially equivalent before and after the modification. Instead, the final regulations list five specific exclusions from the definition of covered modifications, which consist of any modification or a portion of a modification whereby the terms of the contract are modified to change the amount or timing of contractual cash flows and:

(1) that change is intended to induce one or more parties to perform any act necessary to consent to a covered modification;

(2) that change is intended to compensate one or more parties for a noncovered modification;

(3) that change is a concession granted either because a party is experiencing financial difficulty or to account for the credit deterioration of a party;

(4) 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; and

(5) the modification is identified in guidance published in the Internal Revenue Bulletin.

Noncovered modifications do not automatically trigger a reissuance, but rather must be tested under the existing rules set forth in Treasury Regulations § 1.1001-3. Moreover, noncovered modifications that are made contemporaneously with covered modifications are analyzed under § 1.1001-3 with the covered modifications treated as part of the exiting terms of the contract.

The regulations become effective on March 7, 2022; however, they may be applied prior to that date if a taxpayer and all related parties apply them to all modifications occurring prior to March 7, 2022.

Please contact [Eugene G. Bernardo II](#) or [David M. DiSegna](#) at [Partridge Snow & Hahn LLP](#) if you have questions about the final regulations. For additional information and resources visit the firm's [Public Finance Group](#) page.

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