PUBLIC FINANCE

Kutak Rock Client Alert

Services

[Public Finance](#)

[Public Finance Tax](#)

January 11, 2022

Treasury Department Releases Final LIBOR Transition Guidance:

Key Points for Public Finance Community and Municipal Issuers

On January 4, 2022 the Treasury Department published final regulations (the "Final Regulations") providing guidance on the tax consequences of the transition away from the London Interbank Offered Rate (LIBOR) in debt instruments, derivative contracts and other contracts. (LIBOR is offered in multiple currencies and maturities, and for simplicity, they are all referred to herein as LIBOR.) The Final Regulations were released December 30, 2021 and are available online from the Federal Register, 87 Fed. Reg. 166 (Jan. 4, 2022). The Final Regulations finalize proposed regulations (the "Proposed Regulations") that we described in a comprehensive client alert from October 2019. The Final Regulations amplify Rev. Proc. 2020-44, which sets forth certain safe harbor reissuance provisions for modifications that replace LIBOR language with specified fallback language selected by the Alternative Reference Rates Committee (ARRC). Key points in the Final Regulations include the following:

- A modification of a contract to replace a LIBOR rate with an alternative rate (including but not limited to SOFR and BSBY) will not be treated as a taxable exchange of property for other property (i.e., will not lead to a reissuance) if the following requirements are met:
    - *The modification is a "covered modification."* Generally, a covered modification includes: (1) a modification to replace the current applicable rate referencing LIBOR with a qualified rate; (2) a modification to add a fallback rate where the current applicable rate references LIBOR; (3) a modification to replace a fallback rate that references LIBOR with a qualified rate; and (4) a modification to which Rev. Proc. 2020-44 applies (e.g., a modification to implement approved ARRC fallback language). A covered modification may also include certain one-time payments and associated modifications.
    - *The new rate is a "qualified rate."* Generally, a qualified rate includes: (1) a qualified floating rate (but without regard to the limit on multiples that typically restricts by how much the multiple may exceed the base rate); (2) certain alternative rates that may be selected by applicable governmental institutions as a replacement for LIBOR; (3) a rate selected by the ARRC as a replacement for LIBOR; (4) a rate that is determined by reference to a rate

described in 1 through 3 of this paragraph, including a rate that results from adding or subtracting a spread or by multiplying by a specified number; and (5) any other rate that the Treasury Department may specify in subsequent guidance. SOFR and BSBY, for example, are qualified rates.

- *If the new rate consists of one or more fallback rates (for example, a waterfall of fallback rates), each individual fallback rate must separately be a qualified rate.* If the rate of a fallback rate cannot be determined at the time the contract is modified (and the likelihood of such fallback rate applying is not remote), such rate is not considered a "qualified rate," which means the modification with respect to the entire waterfall of rates does not qualify for protection from reissuance. Section 1.1001-6(h)(3)(iv) of the Final Regulations contains several useful examples to illustrate the application of this requirement.
- *The LIBOR rate being replaced must be a "discontinued IBOR."* The LIBOR rate continues to be a discontinued IBOR only until one year after the date on which the administrator of the rate ceases to provide the rate. Effectively, this appears to mean that reissuance protection by the Final Regulations is available only for contracts that are modified not later than one year after the LIBOR index is discontinued.

- Associated modifications, incidental cash payments and qualified one-time payments, all in connection with covered modifications, also will not lead to a reissuance.
  - An "associated modification" is a modification of the technical, administrative or operational terms of a contract that is reasonably necessary to adopt or implement the covered modification. Examples include: a change in the definition of interest period; a change to the timing and frequency of determining rates; and a change in the timing and frequency of making payments of interest.
  - An "incidental cash payment" includes a payment that is intended to compensate a counterparty for small valuation differences resulting from a modification of the administrative terms of a contract. For example, this might include cash payments to address valuation differences resulting from a change in observation period.
  - A "qualified one-time payment" is a single cash payment that is intended to compensate the other party or parties for all or part of the basis difference between the LIBOR rate and the interest rate benchmark to which the new rate refers.

- The following changes to amounts or timing of contractual cash flows are not covered modifications (and are referred to in the Final Regulations as "excluded modifications") and must be tested separately under the existing regulations to determine reissuance consequences, even if made in connection with covered modifications:
  - A change that is intended to induce one or more parties to perform any act necessary to consent to a covered modification.

    - A change that is intended to compensate one or more parties for a modification that is not a covered modification.
    - A change that is either a concession granted to a party to the contract because the 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.
    - A change that is intended to compensate one or more parties for a change in rights or obligations that are not derived from the contract being modified.
    - A change that may be specifically identified in the future by the Internal Revenue Service as having a principal purpose of achieving a result that is unreasonable in light of the purpose of the Final Regulations.

- A covered modification of a qualified hedge or of the bonds with which the hedge is integrated under Treas. Reg. § 1.148-4(h)(1) will not cause the hedge to be terminated, but only if within 90 days of the modification, the hedge again satisfies the requirements to be a qualified hedge. In other words, a simple integrated hedge for purposes of the arbitrage rules will not lose its status as an integrated hedge as long as, within 90 days of the modification of the hedge or the bonds, the hedge terms and bond terms end up complying with the requirements for simple integration.
    - Note that the Final Regulations do not protect a superintegrated hedge from losing its character as a superintegrated hedge as a result of a LIBOR modification. However, such a swap upon amendment for the subsequent index may thereafter qualify as a simple integrated swap.
    - For the purpose of determining whether a hedge may continue to qualify as a simple integrated hedge with respect to bonds, a qualified one-time payment (described above) is allocated in a manner similar to the allocation of a termination payment such that the payment may be treated as a series of periodic payments.

- The fair market value requirement of the Proposed Regulations, along with the historical averages and arm's-length negotiation safe harbors, have been eliminated in the Final Regulations. The Treasury Department acknowledged that the requirement and the safe harbors raised many practical problems and technical issues. The introduction of "covered modifications" and "excluded modifications" is intended to replace the fair market value concept altogether.

- The Final Regulations clarify that neither (1) a covered modification of a contract held by an investment trust nor (2) a covered modification of an ownership interest in the investment trust manifests a power to vary the investment of the certificate holder. In other words, a grantor trust is not disqualified as such simply because of a covered modification. The covered modification is not considered investment discretion.

Public Finance Tax Group

Adam Baird
Spokane
(509) 343-4473
adam.baird@kutakrock.com

Kevin Barney
Chicago
(312) 602-4117
kevin.barney@kutakrock.com

Mitchell Bragin
Washington, D.C.
(202) 828-2450
mitchell.bragin@kutakrock.com

Larry Carlile
Denver
(303) 292-7783
larry.carlile@kutakrock.com

Matthias Edrich
Denver
(303) 292-7783
matthias.edrich@kutakrock.com

Robert Henderson
Omaha
(402) 231-8934
robert.henderson@kutakrock.com

David Lu
Washington, D.C.
(202) 828-2468
david.lu@kutakrock.com

John McGill
Omaha
(402) 231-8974
johnk.mcgill@kutakrock.com

Shawn Willette
Denver
(303) 292-7788
shawn.willette@kutakrock.com

- The Final Regulations do not obsolete Rev. Proc. 2020-44. Rather, as indicated above, Rev. Proc. 2020-44 is amplified. Modifications permitted by the revenue procedure are treated by the Final Regulations as additional "covered modifications."

The Final Regulations are effective for modifications made on and after March 7, 2022. However, a taxpayer may apply the Final Regulations to modifications occurring before March 7, 2022 as long as the taxpayer and all related parties apply the Final Regulations to all modifications of contracts that occur before that date. In other words, if an issuer applies the Final Regulations retroactively, it must do so consistently.

The Final Regulations address certain additional topics not summarized above, including fast-pay stock described in Treas. Reg. § 1.7701(l)-3, REMICS that have issued interests with a LIBOR-based rate or that hold obligations with a LIBOR-based rate, certain foreign corporation elections for computing interest expense and changes in accounting method. Please contact us if you would like more information about these matters.

* * *

The description above represents a summary of the Final Regulations. The specific requirements for covered modifications, excluded modifications and related matters contain additional requirements and details that must be considered in determining the reissuance consequences of transaction modifications. Please be sure to contact any of the attorneys listed on the left in Kutak Rock's National Public Finance Tax Group (Section 103 Tax Group) or another Kutak Rock public finance attorney for assistance in applying the Final Regulations. You may also visit us at www.KutakRock.com.