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Treasury's Final LIBOR Transition Reissuance Regulations

On January 4, 2022 the Treasury Department published final regulations (the "Final Regulations") providing reissuance guidance for the transition away from LIBOR (the London Interbank Offered Rate) to alternate interest rate indices. The following is a summary of the highlights of the Final Regulations. A more detailed outline of the Final Regulations can be found on our website. Please call or email any member of Kutak Rock's National Public Finance Practice Group or National Public Finance Tax Group if you have questions regarding the Final Regulations.

- ***Purpose.*** The purpose of the Final Regulations is to clarify the rules to avoid a taxable event (e.g., a tax reissuance or deemed sale of a debt instrument) when a discontinued LIBOR rate is replaced with a new index rate.

- ***Proposed Regulations.*** The Final Regulations finalize the proposed regulations that were published in October 2019. The Final Regulations do not require the cumbersome historical testing of rates or fair market value analysis that was contemplated in the proposed regulations. Instead, the Final Regulations specifically approve "covered modifications," described below. Any modification that is not described below must be tested under the regular rules for reissuance.

- ***Covered Modifications.*** The following apply for a modification to be a "covered modification":
    - The modification must replace the current applicable LIBOR rate, add a fallback rate where the current rate is a LIBOR rate, replace a fallback rate that currently references a LIBOR rate or implement certain fallback language approved by the Alternative Reference Rates Committee (ARRC) as contemplated in Rev. Proc. 2020-44;
    - The replacement rate must be a "qualified rate," and if the replacement rate consists of a waterfall of rates, each rate in the waterfall must be a "qualified rate";
    - The modification must take place not more than one year after the LIBOR rate being replaced has been discontinued; and
    - Associated modifications, incidental cash payments and qualified one-time payments are allowed.

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- ***Defined Terms.***
    - What is a "qualified rate"? A qualified rate can be the following: (1) a qualified floating rate (this would include SOFR, BSBY and generally any other rate that measures the contemporary cost of borrowed money); (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.
    - What is an "associated modification"? This includes any modification of the technical, administrative or operational terms of a contract that is reasonably necessary to adopt or implement the covered modification.
    - What is an "incidental cash payment"? This includes any 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 the observation period.
    - What is a "qualified one-time payment"? This includes 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.

- ***Swaps.*** What about integrated swaps?
    - Temporary differences in the rate index between a bond and a simple integrated swap will not cause the swap to fail to be a simple integrated swap as long as the differences are resolved within a 90-day grace period.
    - However, such grace period does not apply for superintegrated swaps. Any difference in rate indexes between a bond and a superintegrated swap may cause the superintegration to terminate, although in such a case the swap upon amendment for the subsequent index may thereafter qualify as a simple integrated swap.
    - For purposes of determining whether a swap after the modification continues to qualify as a simple integrated hedge, a qualified one-time payment is allocated in a manner similar to how termination payments are allocated – that is, treated as a series of periodic payments.

- ***Effective Date.*** The Final Regulations are effective for modifications made on and after March 7, 2022. The Final Regulations may be applied to modifications occurring before March 7, 2022 as long as the issuer or borrower, as applicable, applies the Final Regulations consistently to all modifications of contracts.