HAWKINS ADVISORY

FINAL TREASURY REGULATIONS TO ALLOW FOR THE ORDERLY TRANSITION FROM DISCONTINUED IBORS TO ALTERNATIVE INTEREST REFERENCE RATES

Final Treasury Regulations intended to facilitate the transition away from reliance upon the London Interbank Offered Rates and other similarly determined indices ("**IBORs**") to other reference rates were published in the Federal Register on January 4, 2022 (the "**Final Regulations**").

The Final Regulations address modifications made to debt instruments, derivative contracts (hedges) and other contracts to implement replacement reference rates, as well as *fallback rates*, in such contracts. The Final Regulations are the most recent guidance in a continuing effort to provide for an orderly transition away from IBORs and, by so doing, avoid potential market dislocation as the availability of an IBOR index ends or its market use diminishes. Absent such guidance, the modification of an instrument to replace an IBOR with a new reference rate could result in the realization of income, deduction, gain, or loss for federal income tax purposes, or could have other tax consequences to the parties to such instruments.

The Final Regulations state that the replacement rate must (1) be based in the same currency as the original IBOR rate and (2) otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency (this last being a component of the definition of a "qualified floating rate" set forth in Regulation section 1.1275-5(b)(1)) (the "***Qualified Rate Requirements***"). This standard differs significantly from the provisions set forth in the section 1.1001-6 proposed regulations published in the Federal Register on October 9, 2019 (the "**Proposed Regulations**"), which would have required the parties to a debt instrument or other contract to establish substantial equivalence between the fair market value of the original rate and the replacement reference rate.

The Final Regulations supplement guidance provided by the Treasury Department and the Internal Revenue Service (the "**IRS**") in Rev. Proc. 2020-44, 2020-45 I.R.B. 991, released on October 9, 2020 ("**R.P. 2020-44**"). R.P. 2020-44 supports the adoption of such fallback provisions as had been recommended by the Alternative Reference Rate Committee (the "**ARRC**") as of the date of publication of R.P. 2020-44, as well as fallback provisions developed by the International Swaps and Derivatives Association ("**ISDA**") available to the parties to certain derivative contracts for incorporation into such contracts (the "**ISDA 2020 IBOR Fallbacks Protocol**"). R.P. 2020-44 and the Final Regulations both conclude that the adoption of such fallback provisions into existing instruments will not cause such instruments to be considered reissued for tax purposes.

<u>Overview</u>

In general, the Final Regulations provide that "***covered modifications***" will not result in a reissuance of the affected debt instrument or other contract; the following are *covered modifications*:

1) Modifications to the terms of a contract to replace an operative rate that references a "***discontinued IBOR***" with a "***qualified rate***", including the addition of an obligation for one party to make a "***qualified one-time payment***" and any "***associated modifications***";

2) Modifications to the terms of a contract to include a "***qualified fallback rate***", including any "***associated modifications***". A "***fallback rate***" is a rate that becomes effective under the terms of the instrument when the operative rate is no longer available. The Final Regulations contemplate that a ***covered modification*** in respect of *fallback rates* includes both the replacement of existing *fallback rates* that reference *discontinued IBORs* with a *qualified fallback rate* and the addition of a *qualified fallback rate* to existing contracts that did not include *fallback rates*. In addition, the Final Regulations address modifications that provide for "***waterfall fallback rates***".

All other modifications are considered "***noncovered modifications***" and subject to the existing reissuance rules of Regulation sections 1.1001-1(a) and 1.1001-3. *Covered modifications* made to an instrument at the same time as one or more *noncovered modifications* are made, are treated as part of the original instrument and the *noncovered modification(s)* will be tested under the general rules governing whether the instrument has been reissued as a consequence of such *noncovered modification(s)*.

The definitions applicable to these rules are included herein below and are used in the text of this Hawkins Advisory in italics.

<u>Examples; See, Final Regulation section 1.1001-6(j)(6)</u>

An issuer has bonds outstanding in the hands of investors. The bonds pay interest semiannually at a rate of six-month USD LIBOR plus 100 basis points. As USD LIBOR is a *discontinued IBOR*, the issuer and the holders of these bonds agree to modify the instrument and replace the interest rate with a CME Group forward-looking SOFR term rate of a six-month tenor plus an adjustment spread of 42.826 basis points (the ISDA and ARRC recommended adjustment to six-month tenor CME Term SOFR to equate it to six-month USD LIBOR), plus the original spread of 100 basis points.

In this case, the only changes that have been made to the instrument are *covered modifications*. As the replacement rate meets the *Qualified Rate Requirements*, the modification will not result in the bonds being considered reissued, i.e., exchanged for property differing materially in kind or extent.

The same result obtains if rather than the 42.826 percent basis spread adjustment, to be paid on an on-going basis, the parties agree to a one-time payment equal to the present value of such basis spread adjustment, a *qualified one-time payment*.

Any other modifications that do not qualify as "*associated modifications*", including provisions compensating bondholders for their consent to effect the reference rate replacement or provisions reflecting changes in the issuer's financial condition since date the original transaction was entered into, are considered *noncovered modifications* and are to be analyzed under the general rules of Regulation sections 1.1001-1(a) and 1.1001-3.

<u>Provisions Applicable to Qualified Hedges under Section 1.148-4(h) of the Regulations (the "Qualified Hedge Regulations")</u>

Fallback provisions in respect of hedges entered into in connection with tax-advantaged bonds and described in the Qualified Hedge Regulations, are addressed in R.P. 2020-44, as well as in the Final Regulations. In response to provisions set forth in the Proposed Regulations, commentators noted that certain minor mismatches between the terms of the bonds and the terms of the hedge may occur as a consequence of a *covered modification*, and that such mismatches may result in the hedge failing to comply with the requirements of the Qualified Hedge Regulations. In response to this concern, the Final Regulations provide a ***90-day grace period***, which period starts on the date of the first *covered modification*. Any mismatch in terms of the hedge and the bonds will not cause the transaction to cease to qualify under the Qualified Hedge Regulations during the 90-day grace period. Once the grace period is over, however, the requirements of the Qualified Hedge Regulations must be satisfied or the hedge will be considered terminated.

If the parties elect to structure the *covered modification* of a hedge that otherwise complies with the Qualified Hedge Regulations and the *Qualified Rate Requirements* utilizing a *qualified one-time payment*, the Final Regulations allow such *qualified one-time payment* to be allocated in a manner consistent with the allocation of a termination payment in respect of a variable yield bond and treat such payment as a series of periodic payments.

The requirements applicable under the Qualified Hedge Regulations to so-called "super-integrated" hedges are such that the relief provisions of the Final Regulations are determined not to apply to such hedges.

<u>Definitions</u>

A rate is a "***qualified rate***" or a "***qualified fallback rate***" if it is one of the following:

1) A "***qualified floating rate***", as defined in section 1.1275-5(b), but without regard to the limitations on multiples set forth therein; that is to say that the multipliers in connection with a qualified rate are not restricted to multiples greater than 0.65 and not more than 1.35;
2) A rate selected, endorsed or recommended by the central bank, reserve bank, monetary authority, or similar institution, as a replacement for a *discontinued IBOR*;
3) A rate selected, endorsed or recommended by the 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;
4) A rate described in one of the foregoing paragraphs 1), 2), or 3), 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
5) A rate identified as a "*qualified rate*" in guidance published in the Internal Revenue Bulletin (<u>*see*</u>, R.P. 2020-44).

"***Waterfall fallback rates***", *i.e.*, *fallback rates* that are comprised of a series of *fallback rates*. In respect of *waterfall fallback rates*, each rate must be a "*qualified rate*" in order for the *fallback rate* to be considered a "*qualified fallback rate*". If one of the *fallback rates* in the waterfall does not meet the definition of "*qualified rate*" then the *waterfall fallback rate* will not be considered a "*qualified fallback rate*".

In addition, if, at the time of the modification, it is not possible to determine whether a *fallback rate* is a *qualified rate*, the *fallback rate* will not be considered a "*qualified rate*". The Final Regulations provide by way of example, a situation in which the new *fallback rate* is to be determined by the calculation agent at the time the fallback rate is triggered, based on factors that are not guaranteed to satisfy the *Qualified Rate Requirements*; i.e., a *fallback rate* that is described as "based on industry standards at the time of selection" is not a *qualified fallback rate*.

An exception to the foregoing applies to *fallback rates* that are "**remote contingencies**". The Final Regulations state that "if the likelihood that any value will ever be determined under the contract by reference to a *fallback rate* is remote (determined at the time of the modification being tested as a covered modification), that *fallback rate* is treated as satisfying the *Qualified Rate Requirements*.

A "***discontinued IBOR***" is any IBOR in respect of which 1) the administrator announces that it has ceased or will cease to provide the IBOR permanently or indefinitely, and for which no successor administrator is expected, as of the time of the announcement, to continue to provide the IBOR or 2) the regulatory supervisor for the administrator of the IBOR, the central bank for the currency of the IBOR, an insolvency official with jurisdiction over the administrator for the IBOR, a court, or an entity with similar insolvency or resolution authority over the administrator of the IBOR 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. The Final Regulations limit the definition of "*discontinued IBOR*" to such IBORs described in the preceding sentence, but only during the period beginning on the date of the above-referenced announcements and ending on the date that is one year after the date on which the administrator of the IBOR ceases to provide the IBOR.

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 modifications needed to introduce a *qualified rate* or a *qualified fallback* rate into an existing contract; i.e., all *covered modifications* other than *associated modifications*. An *associated modification* includes an incidental cash payment intended to compensate a counterparty for small valuation differences resulting from the modification of the administrative terms of a contract. The Final Regulations include the following examples of "*associated modifications*": a change in the definition of interest period or a change in the timing and frequency of determining rates and making payments of interest, such as delaying payment dates on a debt instrument by two days to allow sufficient time to compute and pay interest at a *qualified rate* computed in arrears.

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 *discontinued IBOR* and the interest rate benchmark to which the *qualified rate* refers. The preamble to the Final Regulations clarifies that any amount in excess of the amount needed to compensate the relevant party for the basis difference between the *discontinued IBOR* and the interest rate benchmark to which the *qualified rate* refers is a *noncovered modification*.

A "***noncovered modification***" is a modification to the terms of the debt instrument or other contract to change the amount or timing of contractual cash flows if the change is:

1) Intended to induce one or more parties to perform any act necessary to consent to a *covered modification*;
2) Intended to compensate one or more parties for a modification to the contract other than a *covered modification*;
3) A concession granted to a party to the contract because that party is experiencing financial difficulties or a concession secured by a party to the contract to account for the credit deterioration of another party to the contract;
4) Intended to compensate one or more parties to the contract for a change in rights or obligations that are not derived from the contract being modified in a *covered modification*; or
5) Otherwise identified in guidance published in the Internal Revenue Bulletin as having a principal purpose of achieving a result that is unreasonable in light of the purpose of the Final Regulations.

Other Laws Addressing the Transition From Discontinued IBORs.

To date, the States of Alabama and New York have adopted legislation that encourages substitution of other reference rates for LIBOR denominated contracts governed by their laws; this legislation reforms such contracts by operation of law if the parties have not done so prior to the effective date of the respective legislation. These laws attempt to eliminate the possibility of civil litigation in response to eligible reference rate changes in the LIBOR denominated contracts to which they apply, but do not address federal tax (such as the reissuance matters addressed in the Final Regulations), regulatory or other issues.

On the federal level, the Adjustable Interest Rate (LIBOR) Act of 2021 (H.R. 4616), as passed by the House of Representatives, would preempt state laws that provide for the selection or use of a replacement reference rate, substitute its own provisions attempting to eliminate civil litigation in response to eligible reference rate changes for LIBOR denominated contracts and effecting change, by operation of law, upon LIBOR termination for such contracts that remain unchanged. Such legislation has not yet been passed by the Senate.

Effective Dates

The Final Regulations apply to modifications to contracts occurring on or after March 7, 2022. A taxpayer may elect to apply provisions of the Final Regulations prior to such date, but only if the Final Regulations are made applicable to all outstanding instruments to which such taxpayer and all its related persons are a party.

Any questions regarding the foregoing may be directed to a member of the Hawkins Delafield & Wood LLP Tax Department.

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