

LIBOR Transition Regulations

By Kaitlyn Coburn, *Manager*

Background:

London Interbank Offered Rate (LIBOR) has historically been the benchmark interest rate at which major global banks lend to one another. A significant amount of debt and nondebt transactions provide for payments based on an IBOR, such as U.S. dollar (USD) LIBOR, which is commonly incorporated in U.S. bank loans.

On March 5, 2021, the ICE Benchmark Administration (IBA) announced that publication of overnight, one-month, three-month, six-month, and 12-month USD LIBOR will cease immediately. To address the elimination of LIBOR, the IRS proposed regulations, which were then finalized on December 30, 2021.

Final Libor Transition Regulations

These final regulations address rules for taxpayers transitioning from interbank offered rates to qualified rates. This provides clarification and guidance of the proposed regulations by providing that “covered modification” made to a contract will not constitute a taxable exchange.

Final Regulations – Highlights:

A covered modification includes four components.

1. Replaces an operative rate referencing a discontinued LIBOR with a qualified rate;
2. includes a qualified rate as a fallback rate (i.e., a rate that will replace an operative rate should the operative rate cease to be published);
3. a modification to replace a fallback rate that refers to a discontinued IBOR with a qualified rate;
4. Associated modifications with regards to those modifications of operative rates or fallback rates.

Additionally, a covered modification cannot be on the listed excluded modifications.

The final regulations limit a qualified one-time payment to the amount equal to the present value of the adjustment - basis difference between the LIBOR reference rate and the qualified rate. Any amount paid in excess is treated as a noncovered modification. The final regulations do not provide guidance on the character or source of the qualified one-time payments.

A noncovered modifications excludes modifications to the amount or timing of contractual cash flows where:

- that change is intended to induce a party to consent to a covered modification;
- the change is intended to compensate a party for a noncovered modification;
- that change is a concession granted to a party on account of its financial difficulty, or a concession secured by one party to account for the credit deterioration of another;
- that change is intended to compensate a party for a change in rights or obligations under a different contract;
- the change is a modification identified in published guidance as having a principal purpose of achieving a result that is unreasonable.

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Under the final regulations if a covered modification and a noncovered modification are made at the same time Reg. §§1.1001-1(a) and 1.1001-3 apply to determine if the noncovered modification will result in a taxable exchange.

Effective Date: The final regulations apply to modifications that occur on or after March 7, 2022. Taxpayers may choose to apply prior to March 7, 2022, provided that the taxpayer and all its related parties apply the final regulations to all modifications before that date. If your lending institution has historically used LIBOR to set your interest rates, now would be a good time to reach out to understand the new rate that will be used going forward.