

# TaxNewsFlash

## United States



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## KPMG report: Outline of measures in IBOR final regulations

The U.S. Treasury Department and IRS late yesterday released for publication in the Federal Register final regulations (T.D. 9961) concerning the tax consequences of the transition away from the use of certain “interbank offered rates” (IBOR) in debt instruments, derivative contracts, and other contracts.

With these [final regulations](#) [PDF 332 KB] (17 pages as published in the Federal Register on January 4, 2022), regulations proposed in October 2019 are finalized.

The following outline provides a summary of certain key provisions based on an initial review of the final regulations. KPMG tax professionals are continuing to study the final regulations and anticipate releasing a more substantive article in the near future. Contact a tax professional listed at the end of this report for more information.

### Overview of final regulations

#### Revisions from measures in proposed regulations

The IRS and Treasury addressed a number of concerns raised by market participants with respect to the proposed regulations. In particular, under the proposed regulations, a contract would not undergo a realization event if the parties modified the contract to replace an IBOR-based rate with a “qualified rate” and made certain “associated modifications.” There were a number of requirements to qualify as a qualified rate under the proposed regulations, including a requirement that the fair market value of the contract after the modification is substantially equivalent to the fair market value of the contract before the modification. While the proposed regulations provided two safe-harbors, market participants raised a number of practical and technical issues with the substantially equivalent requirement.

The final regulations have revised the structure in the proposed regulations. Under the final regulations, a contract does not undergo a realization event if the modification is a “covered modification.” A covered modification must generally include four elements:

- (1) A contract with an operative rate or “fallback provision” that references a discontinued IBOR
- (2) A modification of that contract
  - a. To replace an operative rate that refers to a discontinued IBOR with a qualified rate and, if the parties choose, to add an obligation for one party to make a qualified one-time payment
  - b. To include a qualified rate as a fallback to an operative rate that refers to a discontinued IBOR, or
  - c. To replace a fallback rate that refers to a discontinued IBOR with a qualified rate
- (3) Any associated modification with respect to those modifications of the operative rate or fallback provisions
- (4) The modification satisfies the rules under Reg. section 1.1001-6(j), which excludes certain modifications from the definition of covered modifications

Of particular importance, the final regulations have removed the substantially equivalent requirement in the proposed regulations, and replaced it with the list of excluded modifications in Reg. section 1.1001-6(j). Very generally, the list of excluded modifications includes changes to the amount or timing of contractual cash flows, and the change is intended to:

- Induce one or more parties to perform any act necessary to consent to the modification (e.g., a borrower on a widely held debt instrument agrees to increase the interest rate by a fixed amount for those lenders that agree to replace the discontinued rate with a replacement rate)
- Compensate one or more parties for a modification that is not a covered modification
- Represent a concession granted to a party to the contract because that 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
- Compensate one or more parties for a change in rights or obligations that are not derived from the contract being modified, or
- Represent an item identified in future 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 regulations

### **Other items included in final regulations**

In addition, the final regulations include the following items:

- Many contemplated market transactions will incorporate a fallback provision that provides a “waterfall approach.” Very generally, under a waterfall approach, the fallback provision provides a list of replacement rates. A rate will be selected from the list based on market conditions that exist at the time the IBOR is discontinued. On a later date, the initial replacement rate may also be replaced with a different rate in the waterfall based on changes in market conditions. Taxpayers questioned whether this type of modification would qualify under the proposed regulations. The final regulations clarify that if each individual rate in the waterfall is a qualified rate, the waterfall (collectively) is a qualified rate.
- If at the time of the modification it is not possible to determine whether a fallback rate satisfies the requirements to qualify as a qualified rate (e.g., a calculation agent will determine the fallback rate based on factors that are not guaranteed to produce a qualified rate), the fallback rate is not a qualified rate. However, if the likelihood of using this rate is remote (e.g., the calculation agent is only

used at the end of the waterfall and the likelihood of that occurring is remote), the fallback rate is treated as satisfying the requirements to be a qualified rate.

- If a modification satisfies the requirements in Rev. Proc. 2020-44, it will qualify as a covered modification in the final regulations.
- If a covered modification occurs at the same time as a noncovered modification, the covered modification is treated as part of the terms of the contract prior to the noncovered modification. The noncovered modification is then evaluated under Reg. section 1.1001-1(a) (for non-debt contracts) and Reg. section 1.1001-3 (for debt instruments).
- Similar to the proposed regulations, the final regulations allow taxpayers to make one-time payments to offset changes in value of the contract that result from replacing an IBOR-based rate with a qualified rate.
- The final regulations do not provide clarity with respect to when taxpayers take into account any one-time payments. The preamble to the final regulations indicates that Treasury is still considering how best to address this issue.
- Similar to the proposed regulations, the final regulations provide rules for integrated transactions under Reg. section 1.1275-6 and Reg. section 1.988-5(a), as well as hedging transactions under Reg. section 1.1221-2. The final regulations are intended to prevent negative consequences resulting from covered modifications that are part of a hedging relationship, as long as the modified contracts continue to satisfy the integration and hedging rules.
- Historically, many foreign banks have computed interest expense attributable to excess U.S.-connected liabilities using the methodology in the section 882 regulations that relies on 30-day USD LIBOR. The proposed regulations replaced 30-day USD LIBOR with a yearly average of SOFR. Commentators pointed out that a yearly average of SOFR is generally a significantly lower rate than 30-day USD LIBOR. In the preamble to the final regulations, Treasury and the IRS indicated that they are continuing to study this issue, and until future guidance is issued, foreign banks can apply the yearly average SOFR methodology in the proposed regulations.
- Commentators had questioned whether changing the discount rate for valuing securities under section 475 from a LIBOR-based rate to a qualified rate would be a change in accounting method. The preamble to the final regulations confirms it is not a change in accounting method.

## **Applicability dates**

The final regulations apply to modifications to the terms of a contract that occur on or after March 7, 2022. However, the final regulations can be applied retroactively as long as the taxpayer's related parties also apply the final regulations retroactively.

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