



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-118784-18]

RIN 1545-BO91

Guidance on the Transition from Interbank Offered Rates to Other Reference Rates

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance on the tax consequences of the transition to the use of reference rates other than interbank offered rates (IBORs) in debt instruments and non-debt contracts. The proposed regulations are necessary to address the possibility that an alteration of the terms of a debt instrument or a modification of the terms of other types of contracts to replace an IBOR to which the terms of the debt instrument or other contract refers with a new reference rate could result in the realization of income, deduction, gain, or loss for Federal income tax purposes or could result in other tax consequences. The proposed regulations will affect parties to debt instruments and other contracts that reference an IBOR.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 45 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at <https://www.regulations.gov> (indicate IRS and REG-118784-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-118784-18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-118784-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Caitlin Holzem at (202) 317-4391; concerning submissions of comments and requesting a hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

## **Background**

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 860G, 882, 1001, and 1275 of the Internal Revenue Code (Code).

### *1. Elimination of IBORs*

On July 27, 2017, the U.K. Financial Conduct Authority, the U.K. regulator tasked with overseeing the London interbank offered rate (LIBOR), announced that all currency and term variants of LIBOR, including U.S.-dollar LIBOR (USD LIBOR), may be phased

out after the end of 2021. The Financial Stability Board (FSB) and the Financial Stability Oversight Council (FSOC) have publicly acknowledged that in light of the prevalence of USD LIBOR as the reference rate in a broad range of financial instruments, the probable elimination of USD LIBOR has created risks that pose a potential threat to the safety and soundness of not only individual financial institutions, but also to financial stability generally. In its 2014 report “Reforming Major Interest Rate Benchmarks,” the FSB discussed the problems associated with key IBORs and made recommendations to address these problems, including the development and adoption of nearly risk-free reference rates to replace IBORs. The FSB and FSOC have recognized that a sudden cessation of a widely used reference rate could cause considerable disruptions in the marketplace and might adversely affect the normal functioning of a variety of markets in the United States, including business and consumer lending and the derivatives markets.

The Alternative Reference Rates Committee (ARRC), whose ex-officio members include the Board of Governors of the Federal Reserve System, the Treasury Department, the Commodity Futures Trading Commission, and the Office of Financial Research, was convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York to identify alternative reference rates that would be both more robust than USD LIBOR and that would comply with standards such as the International Organization of Securities Commissions’ “Principles for Financial Benchmarks.” The ARRC was also responsible for developing a plan to facilitate the voluntary acceptance of the alternative reference rate or rates that were chosen. On March 5, 2018, the ARRC published a report that summarizes the work

done earlier to select the Secured Overnight Financing Rate (SOFR) as the replacement for USD LIBOR. The Federal Reserve Bank of New York began publishing SOFR daily as of April 3, 2018, in cooperation with the Office of Financial Research. In addition, the Chicago Mercantile Exchange and other entities have launched trading in SOFR futures and have begun clearing for over-the-counter SOFR swaps. Although SOFR is calculated from overnight transactions, it is possible that one or more term rates based on SOFR derivatives may be added in the future.

Other jurisdictions have also been working toward replacing the LIBOR associated with their respective currencies. The Working Group on Sterling Risk-Free Reference Rates in the United Kingdom chose the Sterling Overnight Index Average (SONIA) to replace British pound sterling LIBOR; the Study Group on Risk-Free Reference Rates in Japan chose the Tokyo Overnight Average Rate (TONAR) to replace yen LIBOR and to serve as an alternative to the Tokyo Interbank Offered Rate (TIBOR); and the National Working Group in Switzerland selected the Swiss Average Rate Overnight (SARON) to replace Swiss franc LIBOR. Alternatives for the relevant IBOR rate have also been selected for Australia, Canada, Hong Kong, and the Eurozone. Other countries are at various stages of selecting a reference rate to replace their respective versions of IBOR.

## *2. Letters on the Tax Implications of the Elimination of IBORs on Debt Instruments and Non-Debt Contracts*

On April 8, 2019, and June 5, 2019, the ARRC submitted to the Treasury Department and the IRS documents that identify various potential tax issues associated with the elimination of IBORs and request tax guidance to address those issues and to facilitate an orderly transition (ARRC letters). The ARRC stated that existing debt

instruments and derivatives providing for IBOR-based payments must be amended to address the coming elimination of IBORs. The ARRC indicated that these amendments will likely take one of two forms. First, the parties may alter the instruments to replace the IBOR-referencing rate with another rate, such as one based on SOFR. Second, the parties may alter the instruments to replace an IBOR-referencing fallback rate with another fallback rate upon the discontinuance of the IBOR or at some other appropriate time. The ARRC describes fallback provisions as the provisions specifying what is to occur if an IBOR is permanently discontinued or is judged to have deteriorated to an extent that its relevance as a reliable benchmark has been significantly impaired. The ARRC notes that, regardless of which of these two forms the amendment takes, the rate that replaces the IBOR-referencing rate may include “(i) appropriate adjustments to the spread above the base reference rate in order to account for the expected differences between the two base reference rates (generally representing term premium and credit risk) and/or (ii) a one time, lump-sum payment in lieu of a spread adjustment.” The ARRC also stated that newer debt instruments and derivatives may already include fallback provisions that anticipate the elimination of an IBOR and provide a methodology for changing the rate when the relevant IBOR becomes unreliable or ceases to exist.

The ARRC letters urged broad and flexible tax guidance in this area. The ARRC letters requested guidance on specific tax issues that arise as a result of these efforts to transition from IBORs to alternative rates. The ARRC first asked that a debt instrument, derivative, or other contract not be treated as exchanged under section 1001 when the terms of the instrument are amended either to replace an IBOR-referencing rate or to include a fallback rate in anticipation of the elimination of the relevant IBOR. The ARRC

noted that these same amendments could cause a taxpayer with a synthetic debt instrument under §1.1275-6 to be treated as legging out of the integrated transaction, and it also sought clarification on the source and character of a one-time payment in lieu of a spread adjustment on a derivative. The ARRC recommended treating SOFR, similar replacement rates for IBOR-referencing rates in other currencies, and potentially any qualified floating rate under §1.1275-5 as permitted alternative reference rates to IBOR-referencing rates. The ARRC further requested that alteration of a regular interest in a real estate mortgage investment conduit (REMIC) to replace an IBOR-referencing rate or to change fallback provisions not prevent the regular interest from having fixed terms on the startup day, and that the existence and exercise of a fallback provision not prevent a variable interest rate on a regular interest in a REMIC from being a permitted variable rate under §1.860G-1. Additionally, the ARRC suggested that, for the purpose of determining the amount and timing of original issue discount (OID) on a debt instrument, an IBOR-referencing qualified floating rate and the fallback rate that replaces the IBOR-referencing rate should be treated as a single qualified floating rate. Finally, the ARRC requested that the reference to 30-day LIBOR in §1.882-5(d)(5)(ii)(B) be amended so that taxpayers may continue to use the simplified method of computing excess interest permitted under that section. The Treasury Department and the IRS received letters from the Structured Finance Industry Group and the Real Estate Roundtable articulating concerns similar to those set forth in the ARRC letters. The comment letters also raised certain issues that are beyond the scope of this regulation.

### *3. Tax Implications of the Elimination of IBORs on Debt Instruments and Non-Debt Contracts*

The following subsections discuss the primary tax issues raised by changes to the terms of debt instruments and non-debt contracts in anticipation of the elimination of IBORs.

#### A. Section 1001

Section 1001 provides rules for determining the amount and recognition of gain or loss from the sale or other disposition of property. The regulations under section 1001 generally provide that gain or loss is realized upon the exchange of property for other property differing materially either in kind or in extent. See §1.1001-1(a). In the case of a debt instrument, §1.1001-3(b) provides that a significant modification of the debt instrument results in an exchange of the original debt instrument for a modified debt instrument that differs materially either in kind or in extent for purposes of §1.1001-1(a). Under §1.1001-3(c), a modification is generally any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument. However, a modification generally does not include an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument. Section 1.1001-3(a)(1) provides that the rules of §1.1001-3 apply to any modification of a debt instrument, regardless of whether the modification takes the form of an amendment to the terms of the debt instrument or an exchange of a new debt instrument for an existing debt instrument. An alteration of a legal right or obligation that is treated as a modification must be tested for significance under §1.1001-3(e). Consequently, changing the interest rate index referenced in a U.S. dollar-denominated debt instrument from USD LIBOR to SOFR if no provision has been made in the terms of the debt instrument for such a change is an alteration of the terms of the debt

instrument that could be treated as a significant modification and result in a tax realization event, even when USD LIBOR no longer exists.

Other than §1.1001-4, which generally prescribes the tax consequences to the nonassigning counterparty when there is a transfer or assignment of a derivative contract by a dealer or a clearinghouse, and §1.1001-5, which addresses the conversion of legacy currencies to the euro, there are no regulations that specifically address when a modification of a derivative or other non-debt contract creates a realization event. This absence of regulations has led to concern that modifying a non-debt contract to reflect the elimination of an IBOR, such as changing the floating rate index referenced in an interest rate swap contract from USD LIBOR to SOFR, could cause a deemed termination of the non-debt contract for tax purposes.

Moreover, a modification of the fallback provisions of a debt instrument or non-debt contract to address the possibility of an IBOR being eliminated might require the parties to recognize income, deduction, gain, or loss. For example, if the terms of a derivative provide for payments at an IBOR-referencing rate but contain no fallback provision, a modification to the terms of the derivative to add a fallback to the IBOR-referencing rate could cause a deemed termination of the derivative. Likewise, if the terms of a debt instrument provide for an IBOR-referencing fallback rate, an alteration of the terms of the debt instrument to replace the IBOR-referencing fallback rate with another fallback rate could cause a deemed exchange of the debt instrument.

## B. Integrated Transactions and Hedges

A debt instrument and one or more hedges may be treated in certain circumstances as a single, integrated instrument for certain specified purposes. For



example, §1.1275-6 describes the circumstances under which a debt instrument may be integrated with a hedge for the purpose of determining the amount and timing of the taxpayer's income, deduction, gain, or loss. Sections 1.988-5(a) (regarding foreign currency transactions) and 1.148-4(h) (regarding arbitrage investment restrictions on tax-exempt bonds issued by State and local governments) similarly provide rules by which a debt instrument may be integrated with a hedge for a specific purpose. In each of these cases, amending an IBOR-referencing debt instrument or hedge to address the elimination of the IBOR may cause a deemed termination or logging out of the integrated hedge that in effect dissolves the integrated instrument into its component parts, which may yield undesirable tax consequences or recognition events for the parties to those instruments.

Similarly, §1.446-4 provides rules by which taxpayers determine the timing of income, deduction, gain, or loss attributable to a hedging transaction. These rules generally state that the method of accounting used by a taxpayer for a hedging transaction must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of the income, deduction, gain, or loss from the item or items being hedged. If a taxpayer hedges an item and later terminates the item but keeps the hedge, the taxpayer must match the built-in gain or loss on the hedge to the gain or loss on the terminated item. Accordingly, amending the terms of a debt instrument or hedge to address the elimination of an IBOR could affect the timing of gain or loss under §1.446-4 if the amendment results in an exchange under section 1001.

### C. Source and Character of a One-Time Payment

The ARRC letters pointed out that, when parties alter the terms of a debt instrument or modify the terms of a non-debt contract to replace a rate referencing an IBOR, the alteration or modification may consist not only of the replacement of the IBOR with a new reference rate such as SOFR but also of an adjustment to the existing spread to account for the differences between the IBOR and the new reference rate. Alternatively, in lieu of (or in addition to) an adjustment to the spread, the parties may agree to a one-time payment as compensation for any reduction in payments attributable to the differences between the IBOR and the new reference rate. In the latter case, questions arise about the source and character of this one-time payment for various purposes of the Internal Revenue Code, such as the withholding rules in sections 1441 and 1442.

#### D. Grandfathered Debt Instruments and Non-Debt Contracts

The requirements of certain statutes and regulations do not apply to debt instruments and non-debt contracts issued before a specific date. For example, an obligation issued on or before March 18, 2012, is not a registration-required obligation under section 163(f) if the obligation was issued under certain arrangements reasonably designed to ensure that the obligation was sold only to non-U.S. persons. If such an obligation is modified after March 18, 2012, in a manner that results in an exchange for purposes of §1.1001-1(a), the modified obligation is treated as reissued and will be a registration-required obligation unless otherwise excepted under section 163(f)(2)(A). Likewise, payments made on certain debt instruments and non-debt contracts outstanding on July 1, 2014, (grandfathered obligations) are exempt from withholding requirements that may otherwise apply under chapter 4 of the Code, subject to any

material modification of a grandfathered obligation that results in the obligation not being treated as outstanding on July 1, 2014. Accordingly, if a debt instrument is altered or a non-debt contract is modified to replace an IBOR-referencing rate in anticipation of the elimination of the IBOR, the debt instrument or non-debt contract may be treated as reissued as a consequence of the alteration or modification and therefore subject to the statute or regulation from which it was previously exempt.

#### E. OID and Qualified Floating Rate

Section 1.1275-5 defines a variable rate debt instrument (VRDI) and provides rules for determining the amount and accrual of qualified stated interest and OID on a VRDI. Under §1.1275-5(b), a VRDI may provide for stated interest at one or more qualified floating rates. A variable rate is generally a qualified floating rate if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. The rate may measure contemporaneous variations in borrowing costs for the issuer of the debt instrument or for issuers in general. However, a multiple of a qualified floating rate is not a qualified floating rate, except as permitted within limited parameters. If a debt instrument provides for two or more qualified floating rates that can reasonably be expected to have approximately the same values throughout the term of the instrument, the qualified floating rates together constitute a single qualified floating rate. Under §1.1275-5(e)(2), if a VRDI provides for stated interest at a single qualified floating rate and certain other requirements are satisfied, the amount of any OID that accrues during an accrual period is determined under the rules applicable to fixed rate debt instruments by assuming that

the qualified floating rate is a fixed rate equal to the value, as of the issue date, of the qualified floating rate.

Section 1.1275-2(h) describes the treatment under sections 1271 through 1275 and the regulations under those sections of a debt instrument with respect to which one or more payments are subject to a remote contingency. Section 1.1275-2(h)(2) provides that a contingency is remote if there is a remote likelihood that the contingency will occur and that, in such a case, it is assumed that the contingency will not occur. In the event that a remote contingency actually occurs, §1.1275-2(h)(6) generally provides that the debt instrument, including a VRDI, that undergoes this “change in circumstances” is treated as retired and then reissued for purposes of sections 1272 and 1273.

In general, if a debt instrument provides for a floating rate of interest and the debt instrument does not qualify as a VRDI, the debt instrument is a contingent payment debt instrument (CPDI) that is subject to more complex and less favorable rules under §1.1275-4. For example, under §1.1275-4, all of the stated interest is OID and the holder and issuer recognize interest income or deductions at times other than when cash payments are made. In addition, if a debt instrument that provides for a floating rate of interest is subject to a contingency that is not a remote contingency, the instrument may be a CPDI. Even if the contingency is remote, if the contingency occurs, the debt instrument is treated as retired and reissued for purposes of the OID rules. In both cases, the treatment of the contingency affects whether the debt instrument has OID and, if so, the amount of the OID and the accruals of the OID over the term of the debt instrument.

The transition to alternative rates, such as SOFR, in connection with the phase-out of IBORs has raised questions under the OID rules. For example, it is not clear whether certain debt instruments that reference IBOR qualify as VRDIs or whether they are subject to non-remote contingencies that must be taken into account.

#### F. REMICs

Section 860G(a)(1) provides in part that a regular interest in a REMIC must be issued on the startup day with fixed terms. Section 1.860G-1(a)(4) clarifies that a regular interest has fixed terms on the startup day if, on the startup day, the REMIC's organizational documents irrevocably specify, among other things, the interest rate or rates used to compute any interest payments on the regular interest. Accordingly, an alteration of the terms of the regular interest to change the rate or fallback provisions in anticipation of the cessation of an IBOR could preclude the interest from being a regular interest.

Section 860G(a)(1) also provides in part that interest payments on a regular interest in a REMIC may be payable at a variable rate only to the extent provided in regulations and that a regular interest must unconditionally entitle the holder to receive a specified principal amount. Section 1.860G-1(a)(3) describes the variable rates permitted for this purpose, and §1.860G-1(a)(5) confirms that the principal amount of a regular interest generally may not be contingent. Notwithstanding these limitations on the payment of principal and interest on a regular interest in a REMIC, §1.860G-1(b)(3) lists certain contingencies affecting the payment of principal and interest that do not prevent an interest in a REMIC from being a regular interest. The list of excepted contingencies does not, however, include a fallback rate that is triggered by an event,

such as the elimination of IBOR, that is likely to occur. Nor does the list expressly include the contingent reduction of principal or interest payments to offset costs incurred by amending a regular interest to replace a rate that refers to an IBOR or by adding a fallback rate in anticipation of the elimination of the relevant IBOR.

Subject to certain exceptions, section 860G(d) imposes a tax equal to 100 percent of amounts contributed to a REMIC after the startup day. If a party other than the REMIC pays costs incurred by the REMIC after the startup day, that payment could be treated as a contribution to the REMIC subject to the tax under section 860G(d).

#### G. Interest Expense of a Foreign Corporation

A foreign corporation applies §1.882-5 to determine its interest expense allocable under section 882(c) to income that is effectively connected with the conduct of a trade or business within the United States. If a foreign corporation uses the method described in §1.882-5(b) through (d), that foreign corporation could have U.S.-connected liabilities that exceed U.S.-booked liabilities (excess U.S.-connected liabilities). When a foreign corporation has excess U.S.-connected liabilities, §1.882-5(d)(5)(ii)(A) generally provides that the interest rate that applies to the excess U.S.-connected liabilities is the foreign corporation's average U.S.-dollar borrowing cost on all U.S.-dollar liabilities other than its U.S.-booked liabilities. Alternatively, §1.882-5(d)(5)(ii)(B) provides that a foreign corporation that is a bank, may elect to use a published average 30-day LIBOR for the year instead of determining its average U.S.-dollar borrowing cost. Because the election provided in §1.882-5(d)(5)(ii)(B) only permits a foreign corporation that is a bank to elect a rate that references 30-day LIBOR, the current election will not be available when LIBOR is phased out.

## **Explanation of Provisions**

### *1. Proposed Substantive Amendments to the Regulations*

The Treasury Department and the IRS have determined that it is appropriate to provide guidance on the tax issues discussed earlier in this preamble in order to minimize potential market disruption and to facilitate an orderly transition in connection with the phase-out of IBORs and the attendant need for changes in debt instruments and other non-debt contracts to implement this transition. The Treasury Department and the IRS expect that this guidance will reduce Federal income tax uncertainties and minimize taxpayer burden associated with this transition.

#### **A. Section 1001**

The proposed regulations under §1.1001-6(a) generally provide that, if the terms of a debt instrument are altered or the terms of a non-debt contract, such as a derivative, are modified to replace, or to provide a fallback to, an IBOR-referencing rate and the alteration or modification does not change the fair market value of the debt instrument or non-debt contract or the currency of the reference rate, the alteration or modification does not result in the realization of income, deduction, gain, or loss for purposes of section 1001. The Treasury Department and the IRS intend that the proposed rules in §1.1001-6(a), as with other regulations under section 1001, apply to both the issuer and holder of a debt instrument and to each party to a non-debt contract. The proposed rules in §1.1001-6(a) also apply regardless of whether the alteration or modification occurs by an amendment to the terms of the debt instrument or non-debt contract or by an exchange of a new debt instrument or non-debt contract for the existing one.

Section 1.1001-6(a)(1) of the proposed regulations provides that altering the terms of a debt instrument to replace a rate referencing an IBOR with a qualified rate (qualified rates are discussed in detail later in this preamble) is not treated as a modification and therefore does not result in a deemed exchange of the debt instrument for purposes of §1.1001-3. This same rule applies to “associated alterations,” which are alterations that are both associated with the replacement of the IBOR-referencing rate and reasonably necessary to adopt or implement that replacement. One example of an associated alteration is the addition of an obligation for one party to make a one-time payment in connection with the replacement of the IBOR-referencing rate with a qualified rate to offset the change in value of the debt instrument that results from that replacement.

Section 1.1001-6(a)(2) of the proposed regulations provides that modifying a non-debt contract to replace a rate referencing an IBOR with a qualified rate is not treated as a deemed exchange of property for other property differing materially in kind or extent for purposes of §1.1001-1(a). The rule also applies to “associated modifications,” which differ from associated alterations only in that they relate to non-debt contracts. The principal example of a non-debt contract for purposes of the proposed regulations is a derivative contract, but the category is also intended to include any other type of contract (such as a lease) that may refer to an IBOR and that is not debt. Thus, for example, if an interest rate swap is modified to change the floating rate leg of the swap from Overnight USD LIBOR plus 25 basis points to an alternative rate referencing SOFR that meets the requirements for a qualified rate under the proposed regulations (including the requirement that the fair market value of the swap



contract after the modification is substantially equivalent to the fair market value of the swap contract before the modification), that modification would not be treated as an exchange of property for other property differing materially in kind or extent and would therefore not be an event that results in the realization of income, deduction, gain or loss under §1.1001-1(a).

Section 1.1001-6(a)(3) of the proposed regulations provides that an alteration to the terms of a debt instrument to include a qualified rate as a fallback to an IBOR-referencing rate and any associated alteration are not treated as modifications and therefore do not result in an exchange of the debt instrument for purposes of §1.1001-3. In addition, an alteration to the terms of a debt instrument by which an IBOR-based fallback rate is replaced with a different fallback rate that is a qualified rate and any associated alteration are also not treated as modifications. Similar rules provide that these same changes to a non-debt contract do not result in the exchange of property for other property differing materially in kind or extent for purposes of §1.1001-1(a).

A coordination rule in §1.1001-6(a)(4) of the proposed regulations makes clear that any alteration to the terms of a debt instrument that is not given special treatment under either §1.1001-6(a)(1) or (3) is subject to the ordinary operation of §1.1001-3. The proposed regulations provide a similar rule for non-debt contracts. These proposed rules contemplate that when an alteration or modification not described in §1.1001-6(a)(1), (2), or (3) occurs at the same time as the alteration or modification described in those paragraphs, the alteration or modification described in §1.1001-6(a)(1), (2), or (3) is treated as part of the existing terms of the debt instrument or non-debt contract and,

consequently, becomes part of the baseline against which the alteration or modification not described in §1.1001-6(a)(1), (2), or (3) is tested.

Section 1.1001-6(b) of the proposed regulations sets forth the rules for determining whether a rate is a qualified rate. Section 1.1001-6(b)(1) lists the rates that may be qualified rates for purposes of §1.1001-6, provided that they satisfy the requirements set forth in §1.1001-6(b)(2) and (3). The list of potential qualified rates in §1.1001-6(b)(1) includes a qualified floating rate as defined in §1.1275-5(b), except that for this purpose a multiple of a qualified floating rate is considered a qualified floating rate. This list also includes any rate selected, endorsed or recommended by the central bank, reserve bank, monetary authority or similar institution (including a committee or working group thereof) as a replacement for an IBOR or its local currency equivalent in that jurisdiction. To avoid any uncertainty on the question of whether the rates identified in §1.1001-6(b)(1)(i) through (viii) may be qualified rates, those rates are individually enumerated even though each is a qualified floating rate, as defined in §1.1275-5(b), and each has been selected by a central bank, reserve bank, monetary authority or similar institution as a replacement for an IBOR or its local currency equivalent in that jurisdiction. The proposed regulations further provide that a rate that is determined by reference to one of the rates listed in §1.1001-6(b)(1) may also be a qualified rate. For example, a rate equal to the compound average of SOFR over the past 30 days may be a qualified rate because that rate is determined by reference to SOFR, which is listed in §1.1001-6(b)(1). To retain the flexibility to respond to future developments, proposed §1.1001-6(b)(1)(xii) provides authority to add a rate to this list by identifying the new rate in guidance published in the Internal Revenue Bulletin.

A rate described in §1.1001-6(b)(1) of the proposed regulations is not a qualified rate if it fails to satisfy the requirement of §1.1001-6(b)(2)(i). Section 1.1001-6(b)(2)(i) of the proposed regulations generally requires that the fair market value of the debt instrument or non-debt contract after the relevant alteration or modification must be substantially equivalent to the fair market value before that alteration or modification. The purpose of this requirement is to ensure that the alterations or modifications described in §1.1001-6(a)(1) through (3) are generally no broader than is necessary to replace the IBOR in the terms of the debt instrument or non-debt contract with a new reference rate. However, the Treasury Department and the IRS recognize that the fair market value of a debt instrument or non-debt contract may be difficult to determine precisely and intend that the proposed regulations broadly facilitate the transition away from IBORs. Accordingly, the proposed regulations provide that the fair market value of a debt instrument or derivative may be determined by any reasonable valuation method, as long as that reasonable valuation method is applied consistently and takes into account any one-time payment made in lieu of a spread adjustment.

To further ease compliance with the value equivalence requirement in §1.1001-6(b)(2)(i), the proposed regulations provide two safe harbors and reserve the authority to provide additional safe harbors in guidance published in the Internal Revenue Bulletin. Under the first safe harbor, the value equivalence requirement is satisfied if at the time of the alteration the historic average of the IBOR-referencing rate is within 25 basis points of the historic average of the rate that replaces it. The parties may use any reasonable method to compute an historic average, subject to two limitations. First, the lookback period from which the historic data are drawn must begin no earlier than 10

years before the alteration or modification and end no earlier than three months before the alteration or modification. Second, once a lookback period is established, the historic average must take into account every instance of the relevant rate published during that period. For example, if the lookback period is comprised of the calendar years 2016 through 2020 and the relevant rate is 30-day USD LIBOR, the historic average of that rate must take into account each of the 60 published instances of 30-day USD LIBOR over the five-year lookback period. Alternatively, the parties may compute the historic average of a rate in accordance with an industry-wide standard, such as a standard for determining an historic average set forth by the International Swaps and Derivatives Association or the ARRC for this or a similar purpose. In any application of this safe harbor, the parties must use the same methodology and lookback period to compute the historic average for each of the rates to be compared.

Under the second safe harbor, the value equivalence requirement of §1.1001-6(b)(2)(i) is satisfied if the parties to the debt instrument or non-debt contract are not related and, through bona fide, arm's length negotiations over the alteration or modification, determine that the fair market value of the altered debt instrument or modified non-debt contract is substantially equivalent to the fair market value of the debt instrument or non-debt contract before the alteration or modification. In determining the fair market value of an altered debt instrument or modified non-debt contract, the parties must take into account the value of any one-time payment made in lieu of a spread adjustment.

A rate described in §1.1001-6(b)(1) of the proposed regulations is also not a qualified rate if it fails to satisfy the requirement in §1.1001-6(b)(3). This paragraph

generally requires that any interest rate benchmark included in the replacement rate and the IBOR referenced in the replaced rate are based on transactions conducted in the same currency or are otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency. As is the case with the value equivalence requirement under §1.1001-6(b)(2)(i), this requirement is intended to ensure that the alterations or modifications described in §1.1001-6(a)(1) through (3) are no broader than necessary to address the elimination of the relevant IBOR.

#### B. Integrated Transactions and Hedges

Section 1.1001-6(c) of the proposed regulations confirms that a taxpayer is permitted to alter the terms of a debt instrument or modify one or more of the other components of an integrated or hedged transaction to replace a rate referencing an IBOR with a qualified rate without affecting the tax treatment of either the underlying transaction or the hedge, provided that the integrated or hedged transaction as modified continues to qualify for integration. For example, a taxpayer that has issued a floating rate debt instrument that pays interest at a rate referencing USD LIBOR and has entered into an interest rate swap contract that permits that taxpayer to create a synthetic fixed rate debt instrument under the integration rules of §1.1275-6 is not treated as legging out of the integrated transaction if the terms of the debt instrument are altered and the swap is modified to replace the USD LIBOR-referencing interest rate with a SOFR-referencing interest rate, provided that in the transaction as modified the §1.1275-6 hedge continues to meet the requirements for a §1.1275-6 hedge. The proposed regulations provide similar rules for a foreign currency hedge integrated with a

debt instrument under §1.988-5(a) and for an interest rate hedge integrated with an issue of tax-exempt bonds under §1.148-4(h). The proposed regulations also provide that, in the case of a transaction subject to the hedge accounting rules under §1.446-4, altering the terms of a debt instrument or modifying the terms of a derivative to replace an IBOR-referencing rate with a qualified rate on one or more legs of the transaction is not a disposition or termination of either leg under §1.446-4(e)(6).

### C. Source and Character of a One-Time Payment

Section 1.1001-6(d) of the proposed regulations provides that, for all purposes of the Internal Revenue Code, the source and character of a one-time payment that is made by a payor in connection with an alteration or modification described in proposed §1.1001-6(a)(1), (2), or (3) will be the same as the source and character that would otherwise apply to a payment made by the payor with respect to the debt instrument or non-debt contract that is altered or modified. For example, a one-time payment made by a counterparty to an interest rate swap is treated as a payment with respect to the leg of the swap on which the counterparty making the one-time payment is obligated to perform. Accordingly, under §1.863-7(b), the source of that one-time payment would likely be determined by reference to the residence of the recipient of the payment. With respect to a lease of real property, a one-time payment made by the lessee to the lessor is treated as a payment of rent and, under sections 861(a)(4) and 862(a)(4), the source of that one-time payment would be the location of the leased real property.

The Treasury Department and the IRS expect that parties to debt instruments and non-debt contracts will generally replace the IBOR with an overnight, nearly risk-free rate, such as SOFR. Because of differences in term and credit risk, an overnight,

nearly risk-free rate will generally be lower than the IBOR it replaces. Accordingly, the Treasury Department and the IRS expect that, for example, one-time payments with respect to a debt instrument will generally not be paid by the lender to the borrower. However, in the event that it is determined that guidance in respect of such payments is needed, the Treasury Department and the IRS request comments on the source and character of a one-time payment on a debt instrument or non-debt contract received by a party (such as the borrower on a debt instrument or the lessee on a lease) that does not ordinarily receive payments during the term of the debt instrument or non-debt contract.

#### D. Grandfathered Debt Instruments and Non-Debt Contracts

The rules in §1.1001-6(a) of the proposed regulations generally prevent debt instruments and non-debt contracts from being treated as reissued following a deemed exchange under section 1001. Thus, for example, a debt instrument grandfathered under section 163(f), 871(m), or 1471 or a regulation under one of those sections would not lose its grandfathered status as a result of any alterations made in connection with the elimination of an IBOR and described in §1.1001-6(a)(1) or (3) of the proposed regulations. To provide certainty in treating a non-debt contract as a grandfathered obligation for chapter 4 purposes in the case of the modification of the contract to replace an IBOR-referencing rate, §1.1001-6(e) of the proposed regulations provides that any modification of a non-debt contract to which §1.1001-6(a)(2) or (3) applies is not a material modification for purposes of §1.1471-2(b)(2)(iv).

#### E. OID and Qualified Floating Rate

Section 1.1275-2(m) of the proposed regulations sets forth three special rules for determining the amount and accrual of OID in the case of a VRDI that provides both for interest at an IBOR-referencing qualified floating rate and for a fallback rate that is triggered when the IBOR becomes unavailable or unreliable. Under §1.1275-2(m)(2), the IBOR-referencing qualified floating rate and the fallback rate are treated as a single qualified floating rate for purposes of §1.1275-5. Under §1.1275-2(m)(3), the possibility that the relevant IBOR will become unavailable or unreliable is treated as a remote contingency for purposes of §1.1275-2(h). Under §1.1275-2(m)(4), the occurrence of the event that triggers activation of the fallback rate is not treated as a change in circumstances. Thus, for example, the VRDI is not treated as retired and reissued under §1.1275-2(h)(6) when the relevant IBOR becomes unavailable or unreliable and the rate changes to the fallback rate, even if the IBOR becoming unavailable or unreliable was a remote contingency at the time the VRDI was issued. With the exception of these three rules in §1.1275-2(m) of the proposed regulations, the OID regulations apply to an IBOR-referencing VRDI as they would to any other debt instrument.

#### F. REMICs

Section 1.860G-1(e) of the proposed regulations permits an interest in a REMIC to retain its status as a regular interest despite certain alterations and contingencies. Specifically, if the parties to a regular interest alter the terms after the startup day to replace an IBOR-referencing rate with a qualified rate, to include a qualified rate as a fallback to an IBOR-referencing rate, or to make any other alteration described in §1.1001-6(a)(1) or (3) of the proposed regulations, §1.860G-1(e)(2) provides that those



alterations are disregarded for the purpose of determining whether the regular interest has fixed terms on the startup day.

Supplementing the list of disregarded contingencies in §1.860G-1(b)(3), §1.860G-1(e)(3) and (4) of the proposed regulations describe certain contingencies affecting the payment of principal and interest that do not prevent an interest in a REMIC from being a regular interest. Under §1.860G-1(e)(3), an interest in a REMIC does not fail to be a regular interest solely because the terms of the interest permit the rate to change from an IBOR-referencing rate to a fallback rate in anticipation of the relevant IBOR becoming unavailable or unreliable. Although this proposed rule permits taxpayers to disregard the contingency in determining whether the rate is a variable rate permitted under §1.860G-1(a)(3), both the IBOR-referencing rate and the fallback rate considered individually must be rates permitted under section 860G. Under §1.860G-1(e)(4) of the proposed regulations, an interest in a REMIC does not fail to be a regular interest solely because the amount of payments of principal or interest may be reduced by reasonable costs of replacing an IBOR-referencing rate with a qualified rate, of amending fallback provisions to address the elimination of an IBOR, or of modifying a non-debt contract that is associated with the interest in the REMIC, such as a credit enhancement. Section 1.860G-1(e)(4) further provides that, if a party other than the REMIC pays those reasonable costs after the startup day, that payment is not subject to the tax imposed under section 860G(d).

#### G. Interest Expense of a Foreign Corporation

Because the election provided in §1.882-5(d)(5)(ii)(B) only permits a foreign corporation that is a bank to elect a rate that references 30-day LIBOR, the current

election will not be available when LIBOR is phased out. To address this change in facts, the proposed regulations amend the election in §1.882-5(d)(5)(ii)(B) to allow a foreign corporation that is a bank to compute interest expense attributable to excess U.S.-connected liabilities using a yearly average SOFR. The Treasury Department and the IRS have determined that SOFR is an appropriate rate to use in §1.882-5(d)(5)(ii)(B) to replace LIBOR. Since SOFR is an overnight rate that does not reflect credit risk, the use of SOFR is likely to result in a lower rate than the 30-day LIBOR calculation previously allowed under §1.882-5(d)(5)(ii)(B). Because of these differences between SOFR and 30-day LIBOR, the Treasury Department and the IRS request comments on whether another nearly risk-free rate might be more appropriate in computing interest expense on excess U.S.-connected liabilities for purposes of §1.882-5(d)(5)(ii)(B).

## *2. Proposed Applicability Dates and Reliance on the Proposed Regulations*

### *A. Proposed Applicability Dates of the Final Regulations*

This part 2(A) of the Explanation of Provisions section describes the various applicability dates proposed to apply to the final regulations. Under the proposed applicability date in §1.1001-6(g), §1.1001-6 of the final regulations would apply to an alteration of the terms of a debt instrument or a modification to the terms of a non-debt contract that occurs on or after the date of publication of a Treasury decision adopting those rules as final regulations in the **Federal Register**. However, under proposed §1.1001-6(g), a taxpayer may choose to apply §1.1001-6 of the final regulations to alterations and modifications that occur before that date, provided that the taxpayer and its related parties consistently apply the rules before that date. See section 7805(b)(7).

Under the proposed applicability date in §1.1275-2(m)(5), the OID rules in §1.1275-2(m) of the final regulations would apply to debt instruments issued on or after the date of publication of a Treasury decision adopting those rules as final regulations in the **Federal Register**. However, under proposed §1.1275-2(m)(5), a taxpayer may choose to apply §1.1275-2(m) of the final regulations to debt instruments issued before that date. See section 7805(b)(7).

Under the proposed applicability date in §1.860G-1(e)(5)(i), the REMIC rules in §1.860G-1(e)(2) and (4) of the final regulations would apply with respect to an alteration or modification that occurs on or after the date of publication of a Treasury decision adopting those rules as final regulations in the **Federal Register**. However, a taxpayer may choose to apply §1.860G-1(e)(2) and (4) of the final regulations with respect to an alteration or modification that occurs before that date. See section 7805(b)(7). Under the proposed applicability date in §1.860G-1(e)(5)(ii), §1.860G-1(e)(3) of the final regulations would apply to a regular interest in a REMIC issued on or after the date of publication of a Treasury decision adopting that rule as a final regulation in the **Federal Register**. However, a taxpayer may choose to apply §1.860G-1(e)(3) of the final regulations to a regular interest in a REMIC issued before that date. See section 7805(b)(7).

Under the proposed applicability date in §1.882-5(f)(3), §1.882-5(d)(5)(ii)(B) of the final regulations would apply to taxable years ending after the date of publication of a Treasury decision adopting that rule as a final regulation is published in the **Federal Register**.

B. Reliance on the Proposed Regulations

A taxpayer may rely on the proposed regulations to the extent provided in this part 2(B) of the Explanation of Provisions section. A taxpayer may rely on §1.1001-6 of the proposed regulations for any alteration of the terms of a debt instrument or modification of the terms of a non-debt contract that occurs before the date of publication of a Treasury decision adopting those rules as final regulations in the **Federal Register**, provided that the taxpayer and its related parties consistently apply the rules of §1.1001-6 of the proposed regulations before that date. A taxpayer may rely on §1.1275-2(m) or §1.860G-1(e)(3) of the proposed regulations for any debt instrument or regular interest in a REMIC issued before the date of publication of a Treasury decision adopting those rules as final regulations in the **Federal Register**. A taxpayer may rely on §1.860G-1(e)(2) and (4) of the proposed regulations with respect to any alteration or modification that occurs before the date of publication of a Treasury decision adopting that rule as a final regulation in the **Federal Register**. A taxpayer may rely on §1.882-5(d)(5)(ii)(B) of the proposed regulations for any taxable year ending after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** but before the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

## **Special Analyses**

### **I. Regulatory Planning and Review – Economic Analysis**

Executive Orders 12866 and 13563 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including (i) potential economic, environmental, and public health and safety effects, (ii) potential distributive impacts, and (iii) equity).

Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

These proposed regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) (MOA) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these proposed regulations as economically significant under section 1(c) of the MOA.

#### A. Background, Need for the Proposed Regulations, and Economic Analysis of Proposed Regulations

A very large volume of U.S. financial products and contracts include terms or conditions that reference LIBOR or, more generally, IBORs. Concern about manipulation and a decline in the volume of the funding from which the LIBOR is calculated led to recommendations for the development of alternatives to the LIBOR, ones that would be based on transactions in a more robust underlying market. In addition, on July 27, 2017, the U.K. Financial Conduct Authority, the U.K. regulator tasked with overseeing LIBOR, announced that all currency and term variants of LIBOR, including USD LIBOR, may be phased out after 2021 and not be published after that timeframe. The ARRC, a group of stakeholders affected by the cessation of the publication of USD LIBOR, was convened to identify an alternative rate and to facilitate its voluntary adoption. The ARRC recommended the SOFR as a potential replacement for USD LIBOR. Essentially all financial products and contracts that currently contain conditions or legal provisions that rely on LIBOR and IBORs are expected to transition

to the SOFR or similar alternatives in the next few years. This transition will involve changes in debt, derivatives, and other financial contracts to adopt the SOFR or other alternative reference rates.

The ARRC has estimated that the total exposure to USD LIBOR was close to \$200 trillion in 2016, of which approximately 95 percent were in over-the-counter derivatives.<sup>1</sup> ARRC further notes that USD LIBOR is also referenced in several trillion dollars of corporate loans, floating-rate mortgages, and similar financial products.

In the absence of further tax guidance, the vast majority of expected changes in such contracts could lead to the recognition of gains (or losses) in these contracts for U.S. income tax purposes and to correspondingly potentially large tax liabilities for their holders. To address this issue, the proposed regulations provide that changes in debt instruments, derivative contracts, and other affected contracts to replace reference rates based on IBORs with qualified rates (as defined in the proposed regulations) will not result in tax realization events under section 1001 and relevant regulations thereunder. The proposed regulations require that qualified rates be substantially equivalent in fair market value to the replaced rates based on any reasonable, consistently applied method of valuation. The proposed regulations further provide certain safe harbors for this comparability standard, based on historic average rates and bona fide fair market value negotiations between unrelated parties. The proposed regulations also provide corresponding guidance on hedging transactions and derivatives to the effect that taxpayers may modify the components of hedged or integrated transactions to replace

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<sup>1</sup> See Second Report, The Alternative Reference Rates Committee, March 2018, Table 1 and related discussion, available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report>.

IBORs with qualified rates without affecting the tax treatment of the hedges or underlying transactions.

In the absence of these proposed regulations, parties to contracts affected by the cessation of the publication of LIBOR would either suffer tax consequences to the extent that a change to the contract results in a tax realization event under section 1001 or attempt to find alternative contracts that avoid such a tax realization event, which may be difficult as a commercial matter. Both such options would be both costly and highly disruptive to U.S. financial markets. A large number of contracts may end up being breached, leading to bankruptcies or other legal proceedings. The types of actions that contract holders might take in the absence of these proposed regulations are difficult to predict because such an event is outside recent experience in U.S. financial markets. This financial disruption would be particularly unproductive because the economic characteristics of the financial products and contracts under the new rates would be essentially unchanged. Thus, there is no underlying economic rationale for a tax realization event.

The Treasury Department and the IRS project that these proposed regulations would avoid this costly and unproductive disruption. The Treasury Department and the IRS further project that these proposed regulations, by implementing the regulatory provisions requested by ARRC and taxpayers, will help facilitate the economy's adaptation to the cessation of the LIBOR in a least-cost manner.

The Treasury Department and the IRS request comments on these proposed regulations.

## *II. Regulatory Planning and Review and Regulatory Flexibility Act*

Under the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities that are directly affected by the proposed regulations. These proposed regulations provide rules to minimize the economic impact of the elimination of IBORs on all taxpayers. Parties to IBOR-referencing financial instruments are generally expected to alter or to modify those instruments in response to the elimination of the relevant IBOR and, in the absence of rules such as those proposed, those alterations and modifications may trigger significant tax consequences for the parties to those instruments. In addition, these proposed regulations do not impose a collection of information on any taxpayers, including small entities. Accordingly, this rule will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### III. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. In 2019, that threshold is approximately \$150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.



#### IV. *Executive Order 13132: Federalism*

Executive Order 13132 (titled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

#### **Comments and Requests for Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. The Treasury Department and the IRS specifically seek comment on any complications under any section of the Code or existing regulations that may arise from the replacement of an IBOR with a qualified rate and that are not resolved in these proposed regulations. All comments will be available at <http://www.regulations.gov> or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

#### **Drafting Information**

The principal authors of these regulations are Caitlin Holzem and Spence Hanemann of the Office of Associate Chief Counsel (Financial Institutions and

Products). However, other personnel from the Treasury Department and the IRS participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order for §1.1001-6 to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

\* \* \* \* \*

Section 1.1001-6 also issued under 26 U.S.C. 148(i), 26 U.S.C. 988(d), and 26 U.S.C. 1275(d).

\* \* \* \* \*

Par. 2. Section 1.860A-0 is amended by adding entries for §1.860G-1(e) to read as follows:

#### **§1.860A-0 Outline of REMIC provisions.**

\* \* \* \* \*

#### **§1.860G-1 Definition of regular and residual interests.**

\* \* \* \* \*

- (e) Transition from interbank offered rates.
- (1) In general.
- (2) Change in reference rate for a regular interest after the startup day.
- (3) Contingencies of rate on a regular interest.
- (4) Reasonable expenses incurred to alter a regular interest.
- (5) Applicability dates.

\* \* \* \* \*

Par. 3. Section 1.860G-1 is amended by adding paragraph (e) to read as follows:

**§1.860G-1 Definition of regular and residual interests.**

\* \* \* \* \*

(e) *Transition from interbank offered rates--(1) In general.* This paragraph (e) applies to certain interests in a REMIC that provide for a rate referencing an interbank offered rate. See §1.1001-6 for additional rules that may apply to an interest in a REMIC that provides for a rate referencing an interbank offered rate.

(2) *Change in reference rate for a regular interest after the startup day.* An alteration to a regular interest in a REMIC that occurs after the startup day and that is described in §1.1001-6(a)(1) or (3) is disregarded in determining whether the regular interest has fixed terms on the startup day under paragraph (a)(4) of this section.

(3) *Contingencies of rate on a regular interest.* An interest in a REMIC does not fail to qualify as a regular interest solely because it is subject to a contingency whereby a rate that references an interbank offered rate and is a variable rate permitted under paragraph (a)(3) of this section may change to a fixed rate or a different variable rate permitted under paragraph (a)(3) of this section in anticipation of the interbank offered rate becoming unavailable or unreliable.

(4) *Reasonable expenses incurred to alter a regular interest.* An interest in a REMIC does not fail to qualify as a regular interest solely because it is subject to a contingency whereby the amount of payments of principal or interest (or other similar amounts) with respect to the interest in the REMIC is reduced by reasonable costs incurred to effect an alteration or modification described in §1.1001-6(a)(1), (2), or (3). In addition, payment by a party other than the REMIC of reasonable costs incurred to

effect an alteration or modification described in §1.1001-6(a)(1), (2), or (3) is not a contribution to the REMIC for purposes of section 860G(d).

(5) *Applicability dates.* (i) Paragraphs (e)(2) and (4) of this section apply with respect to an alteration or modification that occurs on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. However, taxpayers may apply paragraphs (e)(2) and (4) of this section with respect to an alteration or a modification that occurs before the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. See section 7805(b)(7).

(ii) Paragraph (e)(3) of this section applies to a regular interest in a REMIC issued on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. However, a taxpayer may apply paragraph (e)(3) of this section to a regular interest in a REMIC issued before the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. See section 7805(b)(7).

Par. 4. Section 1.882-5 is amended by:

1. Revising the fourth sentence of paragraph (a)(7)(i).
2. Revising paragraph (d)(5)(ii)(B).
3. Removing the “(1)” from the “(f)(1)” paragraph designation and adding a subject heading to paragraph (f)(1).
4. Adding paragraph (f)(3).

The revisions and addition read as follows:

**§1.882-5 Determination of interest deduction.**

(a) \* \* \*

(7) \* \* \*

(i) \* \* \* An elected method (other than the fair market value method under paragraph (b)(2)(ii) of this section, or the published rate election in paragraph (d)(5)(ii) of this section) must be used for a minimum period of five years before the taxpayer may elect a different method. \* \* \*

\* \* \* \* \*

(d) \* \* \*

(5) \* \* \*

(ii) \* \* \*

(B) *Published rate election.* For each taxable year in which a taxpayer is a bank within the meaning of section 585(a)(2)(B) (without regard to the second sentence thereof or whether any activities are effectively connected with a trade or business within the United States), the taxpayer may elect to compute the interest expense attributable to excess U.S.-connected liabilities by using the yearly average Secured Overnight Financing Rate (SOFR) published by the Federal Bank of New York for the taxable year rather than the interest rate provided in paragraph (d)(5)(ii)(A) of this section. A taxpayer may elect to apply the rate provided in paragraph (d)(5)(ii)(A) of this section or in this paragraph (d)(5)(ii)(B) on an annual basis and the taxpayer does not need the consent of the Commissioner to change this election in a subsequent taxable year. If a taxpayer that is eligible to make the published rate election either does not file a timely return or files a calculation with no excess U.S.-connected liabilities and it is later determined by the Director of Field Operations that the taxpayer has excess U.S.-

connected liabilities, then the Director of Field Operations, and not the taxpayer, may choose whether to apply the interest rate provided under either paragraph (d)(5)(ii)(A) or (B) of this section to the taxpayer's excess U.S.-connected liabilities in determining interest expense.

\* \* \* \* \*

(f) \* \* \*--

(1) *General rule.* \* \* \*

\* \* \* \* \*

(3) *Applicability date for published rate election.* Paragraph (d)(5)(ii)(B) of this section applies to taxable years ending after the date of publication of a Treasury decision adopting these rules as final regulations is published in the **Federal Register**.

Par. 5. Section 1.1001-6 is added to read as follows:

**§1.1001-6 Transition from interbank offered rates.**

(a) *Treatment under section 1001--(1) Debt instruments.* An alteration of the terms of a debt instrument to replace a rate referencing an interbank offered rate (IBOR) with a qualified rate as defined in paragraph (b) of this section (qualified rate) and any associated alteration as defined in paragraph (a)(5) of this section (associated alteration) are not treated as modifications and therefore do not result in an exchange of the debt instrument for purposes of §1.1001-3. For example, if the terms of a debt instrument that pays interest at a rate referencing the U.S.-dollar London Interbank Offered Rate (USD LIBOR) are altered to provide that the instrument pays interest at a qualified rate referencing the Secured Overnight Financing Rate published by the Federal Reserve Bank of New York, that alteration of terms is not treated as a modification and therefore does not result in an exchange for purposes of §1.1001-3.

(2) *Non-debt contracts.* A modification of the terms of a contract other than a debt instrument (a non-debt contract) to replace a rate referencing an IBOR with a qualified rate and any associated modification as defined in paragraph (a)(5) of this section (associated modification) are not treated as the exchange of property for other property differing materially in kind or extent for purposes of §1.1001-1(a). A non-debt contract includes but is not limited to a derivative, stock, an insurance contract, and a lease agreement.

(3) *Fallback rate.* An alteration of the terms of a debt instrument to include a qualified rate as a fallback to a rate referencing an IBOR and any associated alteration are not treated as modifications and therefore do not result in an exchange of the debt instrument for purposes of §1.1001-3. In addition, an alteration of the terms of a debt instrument to substitute a qualified rate in place of a rate referencing an IBOR as a fallback to another rate and any associated alteration are not treated as modifications and therefore do not result in an exchange of the debt instrument for purposes of §1.1001-3. A modification of the terms of a non-debt contract to include a qualified rate as a fallback to a rate referencing an IBOR and any associated modification are not treated as the exchange of property for other property differing materially in kind or extent for purposes of §1.1001-1(a). In addition, a modification of the terms of a non-debt contract to substitute a qualified rate in place of a rate referencing an IBOR as a fallback to another rate and any associated modification are not treated as the exchange of property for other property differing materially in kind or extent for purposes of §1.1001-1(a).

(4) *Other contemporaneous alterations and modifications.* Whether an alteration of the terms of a debt instrument that is not described in paragraph (a)(1) or (3) of this section and that is made contemporaneously with an alteration described in paragraph (a)(1) or (3) of this section results in an exchange of the debt instrument is determined under §1.1001-3. Similarly, whether a modification of the terms of a non-debt contract that is not described in paragraph (a)(2) or (3) of this section and that is made contemporaneously with a modification described in paragraph (a)(2) or (3) of this section results in an exchange of property for other property differing materially in kind or extent is determined under §1.1001-1(a). In applying §1.1001-3 or §1.1001-1(a) for this purpose, the altered or modified terms described in paragraph (a)(1), (2), or (3) of this section are treated as part of the terms of the debt instrument or non-debt contract prior to any alteration or modification that is not so described. For example, if the parties to a debt instrument change the interest rate from a rate referencing USD LIBOR to a qualified rate and at the same time increase the interest rate to account for deterioration of the issuer's credit since the issue date, the qualified rate is treated as a term of the instrument prior to the alteration and only the addition of the risk premium is analyzed under §1.1001-3.

(5) *Associated alteration or modification.* For purposes of this section, *associated alteration* or *associated modification* means any alteration of a debt instrument or modification of a non-debt contract that is associated with the alteration or modification by which a qualified rate replaces, or is included as a fallback to, the IBOR-referencing rate and that is reasonably necessary to adopt or to implement that replacement or inclusion. An associated alteration or associated modification may be a



technical, administrative, or operational alteration or modification, such as a change to the definition of interest period or a change to the timing and frequency of determining rates and making payments of interest (for example, 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). An associated alteration or associated modification may also be the addition of an obligation for one party to make a one-time payment in connection with the replacement of the IBOR-referencing rate with a qualified rate to offset the change in value of the debt instrument or non-debt contract that results from that replacement (a one-time payment).

(b) *Qualified rate--(1) In general.* For purposes of this section, a *qualified rate* is any one of the following rates, provided that the rate satisfies the fair market value requirement of paragraph (b)(2) of this section and the currency requirement of paragraph (b)(3) of this section:

(i) The Secured Overnight Financing Rate published by the Federal Reserve Bank of New York (SOFR);

(ii) The Sterling Overnight Index Average (SONIA);

(iii) The Tokyo Overnight Average Rate (TONAR or TONA);

(iv) The Swiss Average Rate Overnight (SARON);

(v) The Canadian Overnight Repo Rate Average (CORRA);

(vi) The Hong Kong Dollar Overnight Index (HONIA);

(vii) The interbank overnight cash rate administered by the Reserve Bank of Australia (RBA Cash Rate);

(viii) The euro short-term rate administered by the European Central Bank (€STR);

(ix) Any alternative, substitute or successor rate selected, endorsed or recommended by the central bank, reserve bank, monetary authority or similar institution (including any committee or working group thereof) as a replacement for an IBOR or its local currency equivalent in that jurisdiction;

(x) Any qualified floating rate, as defined in §1.1275-5(b) (but without regard to the limitations on multiples set forth in §1.1275-5(b)), that is not described in paragraphs (b)(1)(i) through (ix) of this section;

(xi) Any rate that is determined by reference to a rate described in paragraphs (b)(1)(i) through (x) of this section, 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; or

(xii) Any rate identified as a qualified rate in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(a) of this chapter) for purposes of this section.

(2) *Substantial equivalence of fair market value--(i) In general.* Notwithstanding paragraph (b)(1) of this section, a rate is a qualified rate only if the fair market value of the debt instrument or non-debt contract after the alteration or modification described in paragraph (a)(1), (2), or (3) of this section is substantially equivalent to the fair market value of the debt instrument or non-debt contract before the alteration or modification. In determining fair market value for this purpose, the parties may use any reasonable, consistently applied valuation method and must take into account the value of any one-time payment that is made in connection with the alteration or modification. A

reasonable valuation method may (but need not) be based in whole or in part on past or projected values of the relevant rate. The requirements of this paragraph (b)(2)(i) are deemed to be satisfied if the rate meets the safe harbor set forth in paragraph (b)(2)(ii)(A) of this section or if the parties satisfy the safe harbor set forth in paragraph (b)(2)(ii)(B) of this section.

(ii) *Safe harbors--(A) Historic average of rates.* Paragraph (b)(2)(i) of this section is satisfied if, on the date of the alteration or modification described in paragraph (a)(1), (2), or (3) of this section, the historic average of the relevant IBOR-referencing rate does not differ by more than 25 basis points from the historic average of the replacement rate, taking into account any spread or other adjustment to the rate, and adjusted to take into account the value of any one-time payment that is made in connection with the alteration or modification. For this purpose, an historic average may be determined by using an industry-wide standard, such as a method of determining an historic average recommended by the International Swaps and Derivatives Association for the purpose of computing the spread adjustment on a rate included as a fallback to an IBOR-referencing rate on a derivative or a method of determining an historic average recommended by the Alternative Reference Rates Committee (or a comparable non-U.S. organization or non-U.S. regulator) for the purpose of computing the spread adjustment for a rate that replaces an IBOR-referencing rate on a debt instrument. An historic average may also be determined by any reasonable method that takes into account every instance of the relevant rate published during a continuous period beginning no earlier than 10 years before the alteration or modification and ending no earlier than three months before the alteration or modification. For purposes of this safe

harbor, the historic average must be determined for both rates using the same method and historical data from the same timeframes and must be determined in good faith by the parties with the goal of making the fair market value of the debt instrument or non-debt contract after the alteration or modification substantially equivalent to the fair market value of the debt instrument or non-debt contract before the alteration or modification.

(B) *Arm's length negotiations.* Paragraph (b)(2)(i) of this section is satisfied if the parties to the debt instrument or non-debt contract are not related (within the meaning of section 267(b) or section 707(b)(1)) and the parties determine, based on bona fide, arm's length negotiations between the parties, that the fair market value of the debt instrument or non-debt contract before the alteration or modification described in paragraph (a)(1), (2), or (3) of this section is substantially equivalent to the fair market value after the alteration or modification. For this purpose, the fair market value of the debt instrument or non-debt contract after the alteration or modification must take into account the value of any one-time payment that is made in connection with the alteration or modification.

(C) *Published in the Internal Revenue Bulletin.* In guidance published in the Internal Revenue Bulletin, the Commissioner may set forth additional circumstances in which a rate is treated as satisfying the requirement of paragraph (b)(2)(i) of this section (see §601.601(d)(2)(ii)(a) of this chapter).

(3) *Currency of the interest rate benchmark.* Notwithstanding paragraph (b)(1) of this section, a rate is a qualified rate only if the interest rate benchmark to which the rate refers after the alteration or modification described in paragraph (a)(1), (2), or (3) of this

section and the IBOR to which the debt instrument or non-debt contract referred before that alteration or modification are based on transactions conducted in the same currency or are otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency.

(c) *Effect of an alteration of the terms of a debt instrument or a modification of the terms of a derivative on integrated transactions and hedges.* An alteration of the terms of a debt instrument or a modification of the terms of a derivative to replace a rate referencing an IBOR with a qualified rate on one or more legs of a transaction that is integrated under §1.988-5 or §1.1275-6 is not treated as legging-out of the transaction, provided that the §1.1275-6 hedge (as defined in §1.1275-6(b)(2)) or the §1.988-5(a) hedge (as defined in §1.988-5(a)(4)) as modified continues to meet the requirements for a §1.1275-6 hedge or §1.988-5(a) hedge, whichever is applicable. Similarly, an alteration of the terms of a debt instrument or a modification of the terms of a derivative to replace an interest rate referencing an IBOR with a qualified rate on one or more legs of a transaction that is subject to the hedge accounting rules described in §1.446-4 will not be treated as a disposition or termination (within the meaning of §1.446-4(e)(6)) of either leg of the transaction. In addition, a modification to replace an interest rate referencing an IBOR with a qualified rate on a hedging transaction for bonds that is integrated as a qualified hedge under §1.148-4(h) for purposes of the arbitrage investment restrictions applicable to State and local tax-exempt bonds and other tax-advantaged bonds (as defined in §1.150-1(b)) is not treated as a termination of that qualified hedge under §1.148-4(h)(3)(iv)(B), provided that the hedge as modified continues to meet the requirements for a qualified hedge under §1.148-4(h), as

determined by applying the special rules for certain modifications of qualified hedges under §1.148-4(h)(3)(iv)(C).

(d) *Source and character of a one-time payment.* For all purposes of the Internal Revenue Code, the source and character of a one-time payment that is made by a payor in connection with the alteration or modification described in paragraph (a)(1), (2), or (3) of this section is the same as the source and character that would otherwise apply to a payment made by the payor with respect to the debt instrument or non-debt contract that is altered or modified.

(e) *Coordination with provision for grandfathered obligations under chapter 4.* A non-debt contract that is modified only as described in paragraph (a)(2) or (3) of this section is not materially modified for purposes of §1.1471-2(b)(2)(iv).

(f) *Coordination with the OID and REMIC rules.* For rules regarding original issue discount on certain debt instruments that provide for a rate referencing an IBOR, see §1.1275-2(m). For rules regarding certain interests in a REMIC that provide for a rate referencing an IBOR, see §1.860G-1(e).

(g) *Applicability date.* This section applies to an alteration of the terms of a debt instrument or a modification of the terms of a non-debt contract that occurs on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply this section to an alteration of the terms of a debt instrument or a modification of the terms of a non-debt contract that occurs before the date of publication of a Treasury decision adopting these rules as final regulations in

the **Federal Register**, provided that the taxpayers and their related parties consistently apply the rules of this section before that date. See section 7805(b)(7).

Par. 6. Section 1.1271-0 is amended by adding a reserved entry for §1.1275-2(l) and by adding entries for §1.1275-2(m) to read as follows:

**§1.1271-0 Original issue discount; effective date; table of contents.**

\* \* \* \* \*

**§1.1275-2 Special rules relating to debt instruments.**

\* \* \* \* \*

- (l) [Reserved]
- (m) Transition from interbank offered rates.
  - (1) In general.
  - (2) Single qualified floating rate.
  - (3) Remote contingency.
  - (4) Change in circumstances.
  - (5) Applicability date.

\* \* \* \* \*

Par. 7. Section 1.1275-2, as proposed to be amended at 84 FR 47210, September 9, 2019, is further amended by adding paragraph (m) to read as follows:

**§1.1275-2 Special rules relating to debt instruments.**

\* \* \* \* \*

(m) *Transition from interbank offered rates--(1) In general.* This paragraph (m) applies to a variable rate debt instrument (as defined in §1.1275-5(a)) that provides both for a qualified floating rate that references an interbank offered rate (IBOR) and for a methodology to change the IBOR-referencing rate to a different rate in anticipation of the IBOR becoming unavailable or unreliable. See §1.1001-6 for additional rules that may apply to a debt instrument that provides for a rate referencing an IBOR.

(2) *Single qualified floating rate.* If a debt instrument is described in paragraph (m)(1) of this section, the IBOR-referencing rate and the different rate are treated as a single qualified floating rate for purposes of §1.1275-5.

(3) *Remote contingency.* If a debt instrument is described in paragraph (m)(1) of this section, the possibility that the IBOR will become unavailable or unreliable is treated as a remote contingency for purposes of paragraph (h) of this section.

(4) *Change in circumstances.* If a debt instrument is described in paragraph (m)(1) of this section, the fact that the IBOR has become unavailable or unreliable is not treated as a change in circumstances for purposes of paragraph (h)(6) of this section.

(5) *Applicability date.* Paragraph (m) of this section applies to debt instruments issued on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. However, a taxpayer may apply paragraph



(m) of this section to debt instruments issued before the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

See section 7805(b)(7).

Sunita Lough

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2019-22042 Filed: 10/8/2019 8:45 am; Publication Date: 10/9/2019]