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Revenue Procedure 2020-44 Guidance on LIBOR-Related Contract Modifications Adopting Fallback Language

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Treasury and the IRS issued last month additional guidance to taxpayers regarding the market's transition away from the London Interbank Offered Rate ("LIBOR") and other interbank offered rates ("IBORs"). Revenue Procedure 2020-44 provides much needed guidance to market participants that are currently modifying contracts to address this important market event. Broadly, if certain requirements are satisfied, these modifications will not result in a taxable exchange of the contract.

This new guidance addresses certain concerns associated with the 2019 proposed LIBOR regulations, and it shows a willingness of the government to work with taxpayers to limit the tax consequences arising from the LIBOR transition. However, as parties work to modify IBOR contracts, we expect that they will continue to face tax uncertainty, and it is important that tax specialists are involved throughout the process.

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I. Background

In July 2017, the chief executive of the organization charged with regulating LIBOR announced that LIBOR and all current variants (i.e., IBORs, like U.S.-dollar based LIBOR) would most likely be discontinued at the end of 2021.[1] In the United States, the Alternate Reference Rates Committee ("ARRC") was convened to assist in the process of identifying an alternative rate and ensuring a smooth transition.[2] In general, the ARRC is a group composed of market participants and ex officio members of government.[3] In 2018, the ARRC recommended the Secured Overnight Financial Rate ("SOFR") as an alternate rate for USD LIBOR, and the Federal Reserve Bank of New York has published the SOFR daily since April 3, 2018.[4]

The ARRC has provided public comments specifically focused on the modification of existing contracts to incorporate certain "fallback" language. Similarly, the International Swaps and Derivatives Association ("ISDA") has provided model "fallback" language to incorporate into existing derivative contracts, and the ARRC has supported ISDA's efforts.[5] In general, "fallback" language refers to contractual language recommended by the ARRC or ISDA that parties can use in new agreements or when modifying existing contracts in order to identify an alternative rate that can be substituted for an IBOR once it is determined that the IBOR is no longer usable. In general, there are two primary approaches for implementing the new fallback language. First, the "hardwired approach" involves the parties amending contracts to incorporate specific, formulaic terms for determining the replacement rate.[6] Second, the "amendment approach" recognizes that many contracts provide (or will provide) discretion to a person (an administrative agent or a calculation agent, which may be one of the parties to the contract) to determine the appropriate replacement rate and any adjustment spread methodology.[7]

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[1] *See* Andrew Bailey, Chief Executive of the FCA, Speech at Bloomberg London, *The Future of Libor* (July 27, 2017), https://www.fca.org.uk/news/speeches/the-future-of-libor. *See also* Andrew Bailey, Chief Executive of the FCA, Speech at Bloomberg London, *Interest rate benchmark reform: transition to a world without LIBOR* (Dec. 7, 2018) (in which he reiterates the need to transition from LIBOR), https://www.fca.org.uk/news/speeches/interest-rate-benchmark-reform-transition-world-without-libor. For a discussion of the reasons for and consequences of the coming end to LIBOR and other interbank rates, see *The End of LIBOR: A Brief Overview of Potential Tax Consequences Arising from LIBOR's Cessation*, What's News in Tax (Aug. 14, 2019).

[2] *See* Rev. Proc. 2020-44, § 2.01, 2020-45 I.R.B. 991.

[3] Rev. Proc. 2020-44, § 2.02. The ARRC was convened by the Federal Reserve, and its members include the Board of Governors of the Federal Reserve System, as well as members from the Treasury Department, the Commodity Futures Trading Commission, and the Office of Financial Research.

[4] Rev. Proc. 2020-44, § 2.03. In the European Union, the Euro Short-Term Rate ("ESTR"), which is calculated on the wholesale Euro unsecured overnight borrowing costs of Euro area banks, was selected to replace EUR-based LIBOR. *See* Press Release, European Central Bank, www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190314_1~af10eb740e.en.html.

[5] Market participants frequently enter into derivative contracts that are modeled after documents published by ISDA, such as the "2002 ISDA Master Agreement" and the "2006 ISDA Definitions."

[6] *See, e.g.,* Comments Regarding the Guidance on the Transition from Interbank Offered Rates to Other Reference Rates, at 6-7, n.8 (Mar. 24, 2020) ("ARRC March 2020 Letter") (discussing different approaches to resolving the issue, describing a hardwired approach without using that terminology).

[7] *See id.*

The ARRC has provided recommended fallback language for use in a number of cash products, including floating rate notes, bilateral business loans, syndicated loans, securitizations, adjustable rate mortgages, and variable-rate private student loans.[8] In each case, the fallback language describes the circumstances under which references to the current benchmark rate are replaced.[9] When such a circumstance arises, the fallback language generally provides a mechanism for determining the replacement benchmark rate that supplants the current benchmark rate, and may also call for a "spread adjustment" to that rate in an attempt to more accurately replicate the old IBOR.[10]

On October 9, 2020, ISDA published Supplement 70 ("ISDA Supplement"), amending the fallback provisions for rate options that refer to IBORs to provide that, upon the occurrence of certain events, a substitute rate identified in the ISDA Supplement replaces the relevant IBOR.[11] Derivative contracts entered into on or after January 25, 2021 (the effective date of the ISDA Supplement) will generally include the relevant terms of the 2006 ISDA Definitions as amended by the ISDA Supplement; unless modified by the parties, contracts entered into before that date—legacy derivative contracts—will not.[12]

Also on October 9, 2020, to facilitate adoption of the ISDA Supplement by parties to legacy derivative contracts (i.e., contracts entered into before January 25, 2021), ISDA posted the final ISDA 2020 IBOR Fallbacks Protocol (the "ISDA Protocol").[13] The ISDA Protocol will launch publicly and open for adherence on October 23, 2020.[14] If both parties to a contract adhere to the ISDA Protocol, all covered derivative contracts between those parties are generally modified to incorporate the terms of the ISDA Supplement or, in some cases, to incorporate a version of the terms of the ISDA Supplement adapted to fit the existing terms of the contract.[15] ISDA anticipates that, rather than using the protocol, some parties may modify agreements bilaterally on a transaction-by-transaction basis using identical or similar language to that used by parties to the protocol.[16]

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8 Rev. Proc. 2020-44, § 2.03.

9 *Id.*

10 *Id.* On April 8, 2020, the ARRC published its recommended methodology for calculating the spread adjustment, announcing that it "is recommending a spread adjustment methodology based on a historical median over a five-year lookback period calculating the difference between USD LIBOR and SOFR. For consumer products, the ARRC is additionally recommending a 1-year transition period to this five-year median spread adjustment methodology. The five-year median spread adjustment methodology matches the methodology recommended by [ISDA] for derivatives and would make the ARRC's recommended spread-adjusted version of SOFR comparable to USD LIBOR and consistent with ISDA's fallbacks for derivatives markets." This may signal acceptance of a similar rule in forthcoming final regulations in the context of the historical average safe harbor to the FMV test for related parties (as discussed below).

11 Rev. Proc. 2020-44, § 5.04(1). ISDA posted Supplement number 70 to the 2006 ISDA Definitions on October 9, 2020, available at https://www.isda.org. Upon an official announcement or publication regarding the permanent discontinuation or unreliability of USD LIBOR, the ISDA Supplement generally provides that USD LIBOR is replaced by a rate that is the sum of tenor-adjusted SOFR and an adjustment spread based on the historical difference between USD LIBOR and tenor-adjusted SOFR. *See id.* For this purpose, "tenor-adjusted" refers to different maturities, for example, 6-month, 1-year, etc.

12 Rev. Proc. 2020-44, §§ 5.04(1) and (2).

13 Rev. Proc. 2020-44, § 5.04(2).

14 *Id.*

15 *Id.*

16 Rev. Proc. 2020-44, § 5.04(3).

II. 2019 Proposed IBOR Regulations

One year before these announcements, on October 9, 2019, Treasury and the IRS published proposed regulations under section 1001 (and other sections) of the Internal Revenue Code to provide guidance on the tax consequences of replacing an IBOR with an alternate rate or incorporating fallback language in anticipation of LIBOR's disappearance (the "Proposed Regulations").[17]

In general, the Proposed Regulations provide that replacing an existing IBOR with a qualified rate will not be treated as a taxable event if the transaction passes a fair market value ("FMV") test.[18] Qualified rates generally include SOFR and similar rates published by working groups like the ARRC in foreign jurisdictions.[19] Qualified rates also include any variable rate if the variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the instrument is denominated in, or a rate subsequently identified by the IRS.[20]

In general, a modification satisfies the FMV test if the FMV of the modified instrument is substantially equivalent to the FMV of the instrument before the modification.[21] The parties may use any reasonable, consistently applied valuation method and must take into account the value of any one-time payment made in connection with the change to a qualified rate.[22] A reasonable method may (but need not) be based on past or projected values of the relevant rates.[23]

Two safe harbors are provided for taxpayers to satisfy the FMV test. Under the historical average safe harbor, the FMV test is treated as satisfied if the historic average of the instrument's IBOR rate is within 25 basis points of the new rate.[24] Under the arm's length safe harbor, unrelated parties that use bona fide, arm's length negotiations may determine the FMV of the old and new instruments to be equal.[25]

With respect to existing agreements, the Proposed Regulations also provide that a modification to include a qualified rate as a fallback to an IBOR-referencing rate, and a substitution of a qualified rate

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[17] REG-118784-18, 84 Fed. Reg. 54068 (Oct. 9, 2019). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").Taxpayers may rely on the Proposed Regulations prior to finalization, so long as the taxpayer and its related parties consistently apply the rules before that time. Proposed section 1.1001-6(g).

[18] *See* proposed sections 1.1001-6(a)(1) and (2). Modifications must also satisfy a currency test—in general, the new qualified rate must refer to a rate based on transactions in the same currency (e.g., SOFR for USD LIBOR), or a rate reasonably expected to approximate the cost of newly borrowed funds in the same currency—to qualify for relief. *See* proposed section 1.1001-6(a)(3).

[19] *See* proposed section 1.1001-6(b)(1).

[20] *Id.*

[21] *See* proposed section 1.1001-6(b)(2)(i).

[22] *Id.*

[23] *Id.*

[24] *See* proposed section 1.1001-6(b)(2)(ii). Special rules apply to determine an IBOR rate's historic average for this purpose. Importantly, the historic averages are compared "on the date of the modification or alteration." *Id.*

[25] *See* proposed section 1.1001-6(b)(ii)(B).

for an IBOR-referencing rate as a fallback to another rate, are permitted without causing the realization of gain, so long as the modification passes the FMV test.[26]

In general, taxpayers may make other "associated alterations" reasonably necessary to implement the rate change and not jeopardize the treatment of the modification as a nontaxable event.[27] Associated alterations may be technical, administrative, or operational (e.g., a change to the interest period or the timing and frequency of determining the rate or making payments of interest).[28] Associated alterations include one-time payments by one party to another party in connection with the rate change.[29]

Finally, the Proposed Regulations also provide rules regarding integrated and other hedging transactions. In general, a modification qualifying for relief will not cause the "legging out" of an integrated transaction for purposes of section 1.1275-6 or 1.988-5, will not terminate a hedging transaction within the meaning of section 1.446-5, and will not be treated as terminating a hedge for purposes of section 1.148-4(h). The Proposed Regulations expressly require that a hedge under the relevant regulation section continue to meet the requirements for a qualified hedge under that section after the modification.

III. Reaction to the Proposed Regulations

Since the Proposed Regulations' release, the ARRC has provided public comments to the government requesting additional clarity that taxpayers who adopt the ARRC or ISDA fallback language will neither be treated as realizing gain or loss nor be treated as terminating an integrated or hedging transaction.[30] According to the ARRC, it was uncertain whether the Proposed Regulations would exempt all taxpayers who followed the ISDA Protocol and—as the beginning of that process was imminent and was expected and encouraged to be followed by many parties to derivative contracts—immediate guidance was necessary.[31]

The ARRC identified several concerns with the Proposed Regulations and, in particular, with the FMV test. For example, some contracts may have a trigger date to reset a qualified rate that is later than the

[26] *See* proposed section 1.1001-6(a)(3).

[27] *See* proposed sections 1.1001-6(a)(1), (2), (3), and (5).

[28] *See* proposed section 1.1001-6(a)(5). The items listed in the regulations resemble items listed in the definition of "Benchmark Replacement Conforming Changes" in the ARRC's recommended fallback language for certain loans. In general, Benchmark Replacement Conforming Changes are changes made by administrative agents to properly implement fallback language, and the ARRC refers to such changes as "technical, administrative, or operational." *See* ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans, at 6-7 (Aug. 27, 2020), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/Updated-Final-Recommended-Bilateral-Business-Loans-Fallback-Language-August-27-2020.pdf.

[29] The Proposed Regulations provide no relief for any other alterations made contemporaneously with the change in the rate and any associated alterations. Contemporaneous alterations not covered under the proposed rules are tested under the existing rules for determining whether the alteration causes a taxable exchange under section 1.1001-3(e). *See* proposed section 1.1001-6(a)(4).

[30] *See, e.g.,* the ARRC March 2020 Letter; *Guidance Relating to the ISDA Protocol Regarding the Incorporation of Robust Fallback Provisions to IBOR Reference Rates* (Dec. 9, 2019) (the "ARRC December 2019 Letter").

[31] ARRC December 2019 Letter, at 2.

date the contract is modified, a delay that may impede the parties from complying with the historical average safe harbor.[32] Moreover, the ARRC has pointed out that parties to the ISDA Protocol are not engaging in any negotiation with the counterparty, arguably rendering the arm's length standard unavailable to protocol participants.[33] Left with the general FMV test, taxpayers would be forced to make costly valuations that might deter compliance with the ISDA Protocol.[34] The ARRC requested that Treasury and the IRS provide additional guidance that would instead facilitate uptake of the ISDA Protocol.[35]

The ARRC has also supported a rule that would extend the relief provided under the Proposed Regulations for integrated and hedging transactions, even if the debt instrument or hedge did not meet the requirements for integration under the relevant regulations after the change.[36] Specifically, in addition to requesting clarity that a modification to include a fallback would not cause a "legging out" or termination of an integrated or hedging transaction, the ARRC asked for clarity that, if a debt instrument and hedge are integrated under section 1.1275-6 and do not include identical fallback language, the synthetic debt instrument will not be treated as terminated because the debt and hedge no longer meet the requirements for integration.[37]

IV. Revenue Procedure 2020-44

A. Scope

Revenue Procedure 2020-44, which is effective for modifications to contracts on or after October 9, 2020, and before January 1, 2023, but which may also be relied upon by taxpayers retroactively, adopts many of the ARRC recommendations regarding the modification of contracts to include fallback language and the implementation of that language. Importantly, however, changes to contracts that use an "amendment approach" are not covered by Revenue Procedure 2020-44 and will currently need to be analyzed under the Proposed Regulations (or under general section 1001 principles). In general, Revenue Procedure 2020-44 provides that contract modifications within its scope (1) will not be treated as an exchange of property resulting in the realization of gain or loss, and (2) will not cause a taxpayer to be treated as "legging out" or otherwise terminating certain transactions in which a debt instrument and a derivative contract are treated as a single, integrated instrument for tax purposes or when a

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[32] ARRC December 2019 Letter, at 8-10. Under proposed section 1.1001-6(b)(2)(ii)(A), the historic average safe harbor is tested on the day of the modification, so a different trigger date under the contract may affect the economics of the deal enough to exceed the safe harbor threshold (i.e., a 25 basis point (0.0025) change in FMV). *See supra* note 24.

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] ARRC March 2020 Letter, at 5.

[37] A taxpayer, to qualify for integration under either section of the regulations, must be able to compute the yield to maturity of a synthetic debt instrument based on the combined cash flows of a qualifying debt instrument and qualifying hedge. *See* sections 1.988-5(a)(4)(i) and 1.1275-6(b)(2)(i). If those instruments use different replacement rates, it becomes difficult to compute a yield to maturity on the synthetic debt after a modification of both contracts. *See* ARRC March 2020 Letter, at 28-33.

contract is part of a hedging transaction.[38] Revenue Procedure 2020-44 broadly defines the contracts to which it applies, stating that for its purposes "a contract includes but is not limited to a derivative contract, debt instrument, stock, an insurance contract, and a lease agreement."[39]

Modifications within the scope of Revenue Procedure 2020-44, each discussed in more detail below, are:

— A modification to incorporate an ISDA fallback, regardless of whether that modification results from adherence to the ISDA Protocol or by bilateral agreement

— A modification to incorporate an ARRC fallback

— A modification to incorporate either an ISDA fallback or ARRC fallback with certain deviations, so long as the deviations satisfy certain requirements[40]

1. ISDA Fallback Language

For purposes of Revenue Procedure 2020-44, an ISDA fallback is the set of terms provided via the ISDA 2020 IBOR Fallbacks Protocol for contracts referencing any one of six versions of the ISDA Definitions.[41] In general, those terms describe fallback language consistent with the ISDA Supplement.[42] Revenue Procedure 2020-44 applies when a contract is modified to incorporate an ISDA fallback, regardless of whether that modification results from adherence to the ISDA Protocol or a bilateral agreement between the parties to the contract.[43]

2. ARRC Fallback Language

For purposes of Revenue Procedure 2020-44, an ARRC fallback is contract language that is recommended by the ARRC and identified in any one of sections 3.01(2)(i) through (ix) of Revenue

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[38] *See* Rev. Proc. 2020-44, §§ 5.01(1) and (2). Section 6 of Revenue Procedure 2020-44 provides its effective dates and reliance provisions.

[39] Rev. Proc. 2020-44, § 4.01.

[40] Rev. Proc. 2020-44, § 4.02.

[41] The Attachment to the ISDA 2020 IBOR Fallbacks Protocol, publicly available at http://isda.org, at 15, provides fallback language for Protocol Covered Documents incorporating the 2006 ISDA Definitions; Protocol Covered Documents incorporating the 2000 ISDA Definitions; Protocol Covered Documents incorporating the 1991 ISDA Definitions and/or the 1998 Supplement to the ISDA Definitions; Protocol Covered Documents incorporating the 1998 ISDA Euro Definitions; Protocol Covered Documents that reference a Relevant IBOR "as defined," or as having the meaning given, in a Covered ISDA Definitions Booklet; and, Certain Protocol Covered Documents that reference a Relevant IBOR. *See id.* In general, a Protocol Covered Document is a Master Agreement, Confirmation, or Credit Support Document executed before January 25, 2021. *Id.*

[42] *See supra* note11.

[43] *See* Rev. Proc. 2020-44, § 4.02(1).

Procedure 2020-44.[44] Each of those sections, in some cases involving language originally recommended and in other cases updated language, provide fallback language for:

- Closed-end, residential adjustable rate mortgages[45]
- Bilateral business loans, using either:
  - A hardwired approach,[46]
  - A hedged loan approach,[47] or
  - Updated language for the hedged loan and hardwired approaches[48]

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[44] *See* Rev. Proc. 2020-44, §§ 3.01(1) and (2).

[45] Rev. Proc. 2021-44, § 3.01(2)(i) (referring to *Part II: Fallback Language for New Closed-End, Residential Adjustable Rate Mortgages* of the document entitled *ARRC Recommendations Regarding More Robust LIBOR Fallback Contract Language for New Closed-End, Residential Adjustable Mortgages* (Nov. 15, 2019)).

[46] Rev. Proc. 2021-44, § 3.01(2)(ii) (referring to the section entitled *"Hardwired Approach" Fallback Language* of *Part II: Fallback Language for New Originations of LIBOR Bilateral Business Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans* (May 30, 2019)).

[47] Rev. Proc. 2021-44, § 3.01(2)(iii) (referring to the section entitled *Hedged Loan Approach* of *Part II: Fallback Language for New Originations of LIBOR Bilateral Business Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans* (May 30, 2018)). In general, a hedged loan approach involves borrowers entering into interest rate swaps to offset or hedge their floating rate interest exposure. The ARRC explains:

> Such borrowers may wish to avoid any basis risk (*i.e.* any mismatch between the terms of their loan and the related hedge) in the event that LIBOR is discontinued (*i.e.* any mismatch between the terms of their loan and the related hedge). As noted above, there are several ways in which the hardwired approach and amendment approach may not align with the fallbacks ISDA implements for standard derivatives. Any differences are likely to introduce mismatches between loans and related hedges that would not have otherwise arisen and that might not have been anticipated. Market participants may also wish to avoid any complications in accounting, tax or regulatory treatment of such mismatches. To the extent borrowers wish to ensure their bilateral business loan fallbacks are aligned with those for related derivatives referencing the ISDA definitions, the "hedged loan approach" provides certainty in this regard. Note that the benefit of close alignment with derivatives introduces certain costs as it would preclude the fallback to a forward-looking term SOFR rate. Market participants should consider whether they will be prepared from an operational and funding perspective to implement the fallback rate and spread adjustment that are expected to be incorporated into the ISDA definitions at the end of this year. The operational complexities to implementation of the hedged approach may be especially challenging.

The ARRC adds that "ISDA has not analyzed, and will not analyze, whether the fallbacks it anticipates implementing would be appropriate for non-derivatives. The ARRC expects that there will be a tight link between the forward-looking term SOFR rate and the compounded average of SOFR and, therefore, some parties may be comfortable with a basis between the expected fallback rates for loans and derivatives." *See* Hedged Loan Approach, at 30-31 and accompanying footnotes.

[48] Rev. Proc. 2021-44, § 3.01(2)(iv) (referring to *Part II: Fallback Language for New Originations of LIBOR Bilateral Business Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans* (Aug. 27, 2020)).

— Floating rate notes[49]

— Securitizations[50]

— Syndicated loans, using either:

  o A hardwired approach[51] or

  o Updated language for the hardwired approach[52]

— Variable rate student loans[53]

Revenue Procedure 2020-44 provides that the definition of ARRC fallback includes any option or variant identified in the list above, and specifically excludes any option or variant not so identified, even if that option or variant was once recommended by the ARRC.[54] In fact, Revenue Procedure 2020-44 specifically excludes the amendment approach discussed above that was once recommended by the ARRC for bilateral business loans and syndicated loans, indicating the government's reluctance to allow for too much discretion to taxpayers in identifying an alternative rate without requiring satisfaction of the FMV test.[55] Thus, contract modifications that incorporate an amendment approach must be analyzed under the Proposed Regulations.[56]

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[49] Rev. Proc. 2021-44, § 3.01(2)(v) (referring to *Part II: Fallback Language for New Issuances of LIBOR Floating Rate Notes* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of Floating Rate Notes* (Apr. 25, 2019)).

[50] Rev. Proc. 2021-44, § 3.01(2)(vi) (referring to *Part II: Fallback Language for New Issuances of LIBOR Securitizations* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations* (May 31, 2019)).

[51] Rev. Proc. 2021-44, § 3.01(2)(vii) (referring to the section entitled *"Hardwired Approach" Fallback Language* of *Part II: Fallback Language for New Originations of LIBOR Syndicated Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans* (Apr. 25, 2019)).

[52] Rev. Proc. 2021-44, § 3.01(2)(viii) (referring to *Part II: Fallback Language for New Originations of LIBOR Syndicated Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans* (June 30, 2020)).

[53] Rev. Proc. 2021-44, § 3.01(2)(ix) (referring to *Part II: Fallback Language for New Variable-Rate Private Student Loans* of the document entitled *ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Variable-Rate Private Student Loans* (June 30, 2020)).

[54] *See* Rev. Proc. 2020-44, § 3.01(1).

[55] *See id.* at n.2.

[56] Rev. Proc. 2020-44, at n.2 (States that "the fallback rate under the amendment approach is effectively determined by negotiation of the parties to the contract." Hence, the government concludes, "the addition and operation of the fallback provisions in the amendment approach should be evaluated under the standards provided in either the Proposed Regulations or, when published, the final regulations").

3. Deviations from an ISDA Fallback or ARRC Fallback

Under Revenue Procedure 2020-44, deviations from terms incorporated into the definitions of ISDA fallback and ARRC fallback are permissible only if all deviations fall into one or more of the following categories:

- Deviations from the terms of an ARRC fallback or an ISDA fallback that are reasonably necessary to make the terms incorporated into the contract legally enforceable in a relevant jurisdiction or to satisfy legal requirements of that jurisdiction
- Deviations from the terms of an ISDA fallback that are reasonably necessary to incorporate the ISDA fallback into a contract that is not a "Protocol Covered Document" (as defined in the ISDA Protocol)
- Deviations from the terms of an ARRC fallback or an ISDA fallback to omit terms of an ARRC fallback or an ISDA fallback that cannot under any circumstances affect the operation of the modified contract (for example, for a contract that refers only to USD LIBOR, omission of the portions of an ISDA fallback that relate exclusively to contracts referring to another IBOR)
- Deviations from the terms of an ARRC fallback or an ISDA fallback to add, revise, or remove technical, administrative, or operational terms, provided that the addition, revision, or removal is reasonably necessary to adopt or to implement the ARRC fallback or the ISDA fallback (examples of technical, administrative, or operational terms include the definition of interest period, the timing and frequency of determining rates, and the timing and frequency of making payments of interest)[57]

A deviation is not described in one of the four categories above if the deviation obligates one party to make a one-time payment (or similar payments) as a substitute for any portion of an ARRC fallback or an ISDA fallback or as consideration for the modification.[58]

> **KPMG Observation**: A one-time payment is not a permissible deviation under Revenue Procedure 2020-44, however, under the Proposed Regulations a one-time payment may accompany a rate change and associated alterations and not disqualify the transaction from being treated as a non-realization event, if the FMV test is met.
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> The IRS indicated that it may supplement the definition of ARRC fallback in future guidance, providing additional relief as necessary to address developments in the transition away from IBORs.[59] Public comments were requested, specifically regarding the list of allowable deviations from the definitions of ISDA fallback and ARRC fallback.[60]

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[57] *See* Rev. Proc. 2020-44, § 4.02(3)(i)-(iv). The language used to describe items in the final category–"technical, administrative, or operational"–is also found in some of the ARRC's fallback language, more evidence of the government's attempt to accommodate expected market activity around the IBOR transition. *See supra* note 28.

[58] Rev. Proc. 2020-44, § 4.02(3)(iv).

[59] Rev. Proc. 2020-44, § 7.

[60] *Id.*

KPMG Observation: Any modification that deviates from the recommended ARRC fallback language must be closely examined to determine whether it meets the requirements to be treated as a nonrealization event. If the deviation does not fit into any of the four categories, the alteration must be analyzed under the Proposed Regulations (or under general section 1001 principles).

V. Operative Rules for Taxpayers

A. Section 1001

Under section 1001(a) and section 1.1001-1(a), a taxpayer realizes gain or loss when property is sold or exchanged for other property differing materially in kind or in extent. Under section 1001(c), unless otherwise provided, gain or loss realized must be recognized. Section 1.1001-3 provides specific rules for determining when the modification of a debt instrument results in a deemed exchange of the original instrument for the modified debt.[61] The tax consequences of non-debt contract modifications have been developed mostly through the courts, and these modifications may lead to a deemed exchange of an old contract for a new contract.[62] In Revenue Ruling 90-109, the IRS found that the change of the insured under a key employee life insurance policy changed "the fundamental substance of the original contract" and resulted in a realization event for tax purposes, and the "fundamental change" standard is commonly applied to non-debt contract modifications.[63]

Just as in the Proposed Regulations, Revenue Procedure 2020-44—for modifications within its scope—obviates the need to analyze any of this authority. Unlike the Proposed Regulations, however, taxpayers executing modifications within the scope of Revenue Procedure 2020-44 have an easier and more direct route to treating the transaction as a nontaxable event.

Specifically, pursuant to section 5.01 of Revenue Procedure 2020-44, the following transactions will not be treated as an exchange of property for purposes of section 1001:

— A modification to incorporate an ISDA fallback, regardless of whether that modification results from adherence to the ISDA Protocol or by bilateral agreement

[61] Section 1.1001-3(e)(2) provides specific rules for determining when the alteration of a debt instrument is considered a significant modification of that debt instrument, resulting in a deemed exchange of the original debt for the modified instrument, because the modification changes the instrument's yield beyond prescribed limits.

[62] *See, e.g.*, Reily v. Commissioner, 53 T.C. 8, 12 (1969) (finding that the extension of the settlement date of an option affects the "very nature of an option" and can result in a taxable disposition of the original contract), *followed by,* Succession of Brown v. Commissioner, T.C. Memo. 1989-133.

[63] 1990-52 I.R.B. 70. The IRS recently reaffirmed its support for the position expressed in Revenue Ruling 90-109. *See* Estate of McKelvey v. Commissioner, 906 F.3d 26 (2d Cir. 2018), *rev'g* 148 T.C. 312 (2017), *cert. denied sub nom.*, Peters v. Commissioner, 139 S.Ct. 2715 (June 17, 2019), *appeal on other issue pending*, Estate of McKelvey v. Commissioner, No. 26830-14 (T.C.).

- A modification to incorporate an ARRC fallback
- A modification to incorporate either an ISDA fallback or ARRC fallback with certain deviations, so long as the deviations satisfy the requirements discuss above

Compared with the Proposed Regulations, Revenue Procedure 2020-44 provides more targeted relief for modifications incorporating fallback language. Specifically, for alterations adhering (with permitted deviations) to the identified fallback language approved by the ARRC and ISDA, taxpayers can easily conclude that the incorporation of fallback language does not result in a taxable exchange. For contracts that do not qualify under Revenue Procedure 2020-44, taxpayers can still analyze the contracts under the Proposed Regulations or general section 1001 principles. However, this is a more complicated analysis, and under the Proposed Regulations will require the taxpayer to apply the FMV test.

Also, as noted above, contract modifications using an amendment approach do not qualify under Revenue Procedure 2020-44 and must be tested under the Proposed Regulations (or general section 1001 principles). Taxpayers and practitioners should be mindful that, when dealing with the amendment approach, section 1001 considerations may arise both (1) when a contract is modified to include the fallback language, and (2) when the original IBOR is replaced pursuant to the fallback language (i.e., the date the IBOR is no longer reliable).

KPMG Observation: Contract modifications to adopt fallback language, particularly changes involving the ISDA Protocol, are intended to be only one step in the transition from an IBOR. After adopting the fallback language, parties may seek to renegotiate contracts to identify and install a permanent replacement rate. Until further guidance is released, the tax consequences of subsequent modifications may be identified and analyzed under the Proposed Regulations (or general section 1001 principles).

B. Effects on Integrated Transactions

Various provisions of the Code and regulations permit taxpayers to connect the tax consequences of one or more contracts for tax purposes. Section 1.1275-6 allows a taxpayer to integrate a qualifying debt instrument with one or more derivative contracts qualifying as a section 1.1275-6 hedge to create a synthetic debt instrument for tax purposes.[64] Sections 1.148-4(h) and 1.988-5(a) also provide rules to allow taxpayers to integrate a debt instrument with a derivative contract.[65] Similarly, section 1.446-4 provides rules for the proper method of accounting for derivative contracts that qualify as a hedging

[64] *See* section 1.1275-6 (providing rules allowing for integration of a qualifying debt instrument with a qualifying hedge, if certain requirements are satisfied including timely identification). *See also supra* note 39, discussing qualification for integration under section 1.1275-6.

[65] *See* section 1.148-4(h) (providing rules allowing certain payments on qualified hedges of tax-exempt bonds to be taken into account to determine the issue's yield); section 1.988-5(a) (providing rules allowing for the integration of a qualifying debt instrument and section 1.988-5 hedge in a qualified hedging transaction, eliminating separately recognized exchange gain or loss on the debt and the hedge while both are part of the hedging transaction). *See also supra* note 39, discussing qualification for integration under section 1.988-5(a).

transaction, generally providing that the timing and character of items related to the contract should reasonably match the timing and character of the item or items being hedged.[66]

Revenue Procedure 2020-44 adopts the recommendations of the ARRC and provides rules ensuring that contract modifications within its scope do not affect the integrated treatment of transactions that involve the contract. Specifically, section 5.02 of Revenue Procedure 2020-44 provides that:

- If a contract is one leg of a transaction integrated under section 1.1275-6 or 1.988-5(a), then the modification of that contract is not treated as legging out of the integrated transaction under section 1.1275-6 or 1.988-5(a);
- If a contract is integrated under section 1.148-4(h), then the modification of that contract is not treated as terminating the qualified hedge under section 1.148-4(h); and
- If a contract is part of a hedging transaction under section 1.446-4, then the modification of that contract is not treated as a disposition or termination of either leg of the transaction under section 1.446-4.

Importantly, for modifications within the scope of Revenue Procedure 2020-44 that potentially have consequences for an integrated or hedging transaction, Revenue Procedure 2020-44 removes the requirement under the Proposed Regulations to re-test whether the debt instrument and hedge continue to qualify for integrated treatment after the modification.

C. Associated Changes

Revenue Procedure 2020-44 provides that if the contract alteration involves covered modifications (i.e., those modifications within the scope of the revenue procedure) and other, noncovered modifications, the noncovered modifications are subject to the applicable sections of the regulations for the transaction.[67] For purposes of those regulations, any covered modifications are treated as part of the unmodified instrument.[68] Therefore, covered modifications are treated as part of the existing terms of the contract against which other contemporaneous, subsequent, or cumulative modifications are tested under the applicable regulations.[69] Thus, for example, if parties modify a debt instrument to both adopt an ISDA fallback and, for a fee, change the payment schedule on the obligation, when testing whether the uncovered payment schedule modification results in a change in yield sufficient to trigger a deemed exchange of the debt under section 1.1001-3, the yield of the unmodified instrument is treated as already incorporating the ISDA fallback language.[70]

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[66] *See* section 1.446-4(a), applying rules for hedging transactions as defined in section 1.1221-2(b) (defining hedging transaction to generally mean any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily to manage risks with respect to property or obligations of the taxpayer).

[67] Rev. Proc. 2020-44, § 5.03.

[68] *Id.*

[69] *Id.*

[70] *See* section 1.1001-3(e)(2). The debt modification in this example would also be tested under section 1.1001-3(e)(3) relating to changes in the timing of payments. This language also suggests that modifications within the scope of Revenue Procedure 2020-44 are not treated as "insignificant" modifications that, although not alone causing a taxable event, must be

Conclusion

Revenue Procedure 2020-44, along with the Proposed Regulations, should provide welcome guidance to taxpayers that have products that will be affected by the transition away from IBORs. Careful planning, along with good coordination between a taxpayer's treasury and tax functions, are essential to ensure that the transition away from LIBOR happens smoothly and without any unexpected tax consequences. There are various options available and decisions that need to be made in managing the transition and associated modifications, and, consequently, there exists the potential for tax and transfer pricing controversy in the future. As always, careful documentation is highly recommended.

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taken into account cumulatively when testing subsequent modifications. Section 1.1001-3(f)(3). In other words, changes within the scope of Rev. Proc. 2020-44 are not even considered alterations within the meaning of section 1.1001-3(c)(1)(i).

