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PUBLIC FINANCE ADVISORY

IRS Releases Interim “Fallback” Guidance for Updating Financial Instruments to Account for LIBOR and IBOR Phaseout

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On October 9, 2020, the Internal Revenue Service released Revenue Procedure 2020-44 (the Rev. Proc.) to provide guidance for the market’s transition from the U.S. dollar-based London Interbank Offered Rate (LIBOR) and other interbank offered rates (IBORs) to different reference rates upon a reference rate dissolution. The Rev. Proc. is the latest response to the announcement that LIBOR, which is widely used as a reference rate in variable-rate financial instruments, will be phased out after the end of the year 2021.

The United States Treasury Department has previously released proposed regulations (the Proposed Regulations) on how an amendment to specific financial instruments will be treated to account for the phasing out of LIBOR. (See prior coverage here.)

The IRS released the Rev. Proc. to provide additional interim guidance, separate from the Proposed Regulations, to address modifying financial instruments to replace IBORs or to add “fallback provisions” to IBORs. Specifically, the Rev. Proc. addresses comments and recommendations from (1) the Alternative Reference Rates Committee (ARRC) and (2) the International Swaps and Derivatives Association (ISDA).

ARRC RECOMMENDS SOFR AS LIBOR ALTERNATIVE

As an initial matter, the Rev. Proc. notes that ARRC, whose ex-officio members comprise governors of the Federal Reserve System, the Department of the Treasury, the Commodity Futures Trading Commission, and the Office of Financial Research, convened to identify an alternative to LIBOR. ARRC considered a comprehensive list of LIBOR alternatives and ultimately recommended the Secured Overnight Financing Rate (SOFR) as the replacement for LIBOR. SOFR is published by the Federal Reserve Bank of New York.

ARRC PROVIDES LANGUAGE FOR CASH PRODUCTS, INCLUDING FLOATING RATE NOTES, BILATERAL BUSINESS LOANS, SYNDICATED LOANS, SECURITIZATIONS, ADJUSTABLE RATE MORTGAGES, AND VARIABLE-RATE PRIVATE STUDENT LOANS

ARRC also published recommended fallback language for inclusion in the terms of certain newly issued cash products, including floating rate notes, bilateral business loans, syndicated loans, securitizations, adjustable rate mortgages, and variable-rate private student loans. The fallback language describes the circumstances under which references to the current LIBOR benchmark rate may be replaced. The fallback language published by ARRC also generally provides a mechanism for determining the spread adjustment to the replacement benchmark rate (SOFR) to account for the change in reference rates. The published language generally applies to newly issued cash products but may also be used in the modification of existing cash products to incorporate appropriate fallback language. It is important to note, as discussed below, that the Rev. Proc. approves certain fallback language published by ARRC (an ARRC Fallback), but only the language in the Rev. Proc. will receive the favorable treatment described in the Rev. Proc., and other fallback language that may have been published by ARRC may not necessarily receive the same treatment.

ISDA PUBLISHES DEFINITION SUPPLEMENT FOR DERIVATIVE CONTRACTS

ARRC worked with ISDA to address the potential phaseout of IBORs in derivative contracts (e.g., interest rate swaps) governed by ISDA documents. Specifically, ISDA published a supplement to the 2006 ISDA Definitions to facilitate the inclusion of new fallbacks for certain key IBORs in derivative transactions entered into after January 25, 2021, (the ISDA Supplement). The ISDA Supplement identifies substitute rates for certain IBORs upon the discontinuation or unreliability of the original reference rate. For LIBOR, the ISDA Supplement specifies a rate that is the sum of a term-adjusted SOFR (referred to as "tenor-adjusted" in the Rev. Proc.), along with an adjustment spread, as a substitute.

For contracts entered into prior to January 25, 2021, (Legacy Contracts), the ISDA Supplement will generally not apply unless the parties otherwise agree. ISDA published its ISDA 2020 IBOR Fallbacks Protocol (the ISDA Protocol) and suggested forms of bilateral contracts to facilitate adoption of the ISDA Supplement in Legacy Contracts. Among other things, the ISDA Protocol provides a set of terms to integrate into various ISDA documents (each an ISDA Fallback). If parties to Legacy Contracts adhere to the ISDA Protocol, all covered derivative contracts between those parties are generally modified to incorporate the terms of the ISDA Supplement. A bilateral contract can also be used to modify one or more Legacy Contracts to incorporate the terms of the ISDA Supplement.

IRS NARROWS SCOPE OF IBOR REPLACEMENT LANGUAGE THAT DOES NOT TRIGGER 1001 EVENT

The Rev. Proc. generally follows the previously issued Proposed Regulations with regard to reissuances, but it is more specific on what will *not* trigger a reissuance under Treas. Reg. Section 1.1001-1(a). Specifically, the Rev. Proc. indicates that an instrument will not be deemed to be re-issued if:

- A contract is modified to incorporate an ISDA Fallback (regardless of whether the contract adheres to the ISDA Protocol or a bilateral agreement)
- A contract is modified to incorporate an ARRC Fallbackr

- Or a contract is modified to incorporate the terms of either an ARRC Fallback or an ISDA Fallback with certain deviations (where the deviations are specified in the Rev. Proc.).

As noted above, the Rev. Proc. is very specific as to the language that will meet the requirements, and language that is not provided in the Rev. Proc. may not receive the same favorable treatment. Whether language will meet the definitions of an ISDA Fallback or an ARRC Fallback is a key analysis and should be considered carefully.

The Rev. Proc. adopts a similar stance for certain other tax purposes. For example, if an interest rate swap with a LIBOR benchmark is "integrated" with a tax-exempt floating rate bond under the qualified hedge rules of Reg. 1.148-4(h), the modification of the swap with the ISDA Fallback language as described above will not terminate the qualified hedge under Reg. 1.148-4(h).

EFFECTIVE DATE AND ADDITIONAL GUIDANCE

The Rev. Proc. is effective for modifications occurring on or after October 9, 2020, and before January 1, 2023. A taxpayer, however, may rely on the Rev. Proc. for modifications to contracts occurring before October 9, 2020. The IRS and the Treasury Department may provide additional relief to address later developments. The IRS asks for comments related to the specified deviation to ARRC Fallbacks and ISDA Fallbacks.

HELPFUL LINKS

Links to the Rev. Proc. and certain ARRC and ISDA materials are below.

- Rev. Proc. 2020-44
- ARRC Fallback Contract Language
- ISDA 2020 Fallbacks Protocol and Attachments