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March 12, 2020

Re: Comments regarding the Guidance on the Transition from Interbank Offered Rates to Other Reference Rates

Ladies and Gentlemen:

The Alternative Reference Rates Committee (the "ARRC"), a committee convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York, whose ex officio members also include a number of other governmental institutions including the U.S. Department of the Treasury, is writing to provide comments regarding the Guidance on the Transition from Interbank Offered Rates to Other Reference Rates published by the U.S. Department of the Treasury and the Internal Revenue Service (together referred to herein as "Treasury") in the Federal Register on October 9, 2019 (the "Proposed Regulations"). The Proposed Regulations address many of the tax issues raised by the market transition from interbank offered rates ("IBORs") to alternative reference rates, including the transition from the

London Interbank Offered Rate (“LIBOR”) to the Secured Overnight Financing Rate (“SOFR”). Prior to the issuance of the Proposed Regulations, the ARRC provided comments on these and other issues in a letter dated April 8, 2019 (the “ARRC April 2019 Letter”) and a supplemental submission dated June 5, 2019 (the “ARRC June 2019 Supplemental Submission”).<sup>1</sup>

The ARRC appreciates the timely guidance provided by the Proposed Regulations and the significant efforts of Treasury to respond to concerns relating to the IBOR transition, particularly in light of the various ongoing guidance projects necessitated by tax reform legislation. Treasury provided comprehensive guidance addressing most of the concerns raised by the ARRC in a manner that gives significant flexibility to taxpayers seeking to transition away from IBORs.

The ARRC believes that the relief provided by the Proposed Regulations will aid substantially in an orderly market transition away from IBORs. However, certain requirements in Proposed Section 1.1001-6,<sup>2</sup> which addresses the circumstances under which an alteration of or modification to a contract will cause a deemed termination, present practical concerns that create uncertainty for market participants. These practical concerns may deter market participants from entering into modifications to transition from an IBOR to an alternative reference rate or from adopting robust market-wide contractual fallback provisions in response to the expected IBOR cessation, increasing market risk and posing a potential threat to financial stability. Therefore, the ARRC respectfully requests that Treasury revise portions of the Proposed Regulations as discussed herein. The ARRC also provides certain other recommendations with regards to one-time payments, the integration and hedging transaction rules, the OID regulations, fixed investment trusts, fast-pay stock and accounting methods.<sup>3</sup>

The ARRC submitted a preliminary comment letter dated December 9, 2019 (the “ARRC December 2019 Letter”)<sup>4</sup> addressing the deterrent effect some of these concerns and uncertainties may have on the adherence by market participants to the protocol on IBOR discontinuation that is expected to be published by the International Swaps and Derivatives Association (“ISDA”) in 2020 (the “Protocol”).<sup>5</sup> The ARRC provided additional materials

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<sup>1</sup> The ARRC April 2019 Letter is available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Tax-Whitepaper-April2019.pdf>. The ARRC June 2019 Supplemental Submission is available at [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC\\_Proposed\\_Transition\\_Guidance.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC_Proposed_Transition_Guidance.pdf).

<sup>2</sup> Except as otherwise indicated, all “Proposed Section” references refer to sections of the Proposed Regulations, and all “Section” references refer to sections of the Internal Revenue Code of 1986, as amended (the “Code”), or to sections of the Treasury Regulations promulgated thereunder.

<sup>3</sup> The ARRC has no comments on Proposed Section 1.882-5 (determining the interest expense of a foreign corporation).

<sup>4</sup> The ARRC December 2019 Letter is available at [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC\\_Tax\\_Letter\\_re\\_ISDA\\_Protocol.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC_Tax_Letter_re_ISDA_Protocol.pdf).

<sup>5</sup> On February 24, 2020, ISDA launched a consultation on how to implement pre-cessation fallbacks for derivatives, and aims to publish the results of this consultation and information on next steps for implementing derivatives fallbacks in late April or early May. See 2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives, <https://www.isda.org/a/iioTE/2020-Consultation-on-Pre-Cessation-Issues-Final.pdf>.

regarding the Protocol, including examples of the manner in which market participants may bilaterally agree to amendments that are substantially similar to those effectuated by the Protocol, and certain issues pertaining to the integration rules of Sections 1.1275-6 and 1.988-5 and the hedging transaction rules of Sections 1.446-4 and 1.148-4(h) in a supplemental submission dated December 20, 2019 and an additional supplemental submission dated January 30, 2020 (together with the ARRC December 2019 Letter, the “ARRC ISDA Submissions”). ISDA has announced that, at the time the Protocol is published, it will publish Amended Definitions (as defined in the ARRC December 2019 Letter) that will contain robust market-wide IBOR fallbacks.<sup>6</sup> As discussed in the ARRC December 2019 Letter, guidance prior to or contemporaneous with the publication of the Protocol is important in order to encourage broad market adherence to the Protocol, as well as to facilitate bilateral contractual modifications that are substantially similar to those resulting from adherence to the Protocol.

The ARRC ISDA Submissions were focused specifically on the Protocol and related fallback provisions in the interest of time. In this letter, the ARRC provides more general comments to the Proposed Regulations that expand on its recommendations in the ARRC April 2019 Letter, the ARRC June 2019 Supplemental Submission and the ARRC ISDA Submissions.

## **I. Summary of Recommendations**

### **A. Recommendations Regarding Proposed Section 1.1001-6**

*Proposed Section 1.1001-6(a): Add a “fast track” provision for the implementation of standard market-wide fallback provisions*

1. The ARRC recommends adding a rule to Proposed Section 1.1001-6(a) stating that if the only modifications to a contract are ones incorporating the ARRC fallback provisions, the ISDA fallback provisions or provisions substantially similar to either those recommended by the ARRC or those recommended by ISDA, such modifications will not be treated as a taxable event under Section 1001.

*Proposed Section 1.1001-6(b)(2): Amend the fair market value requirement*

2. The ARRC recommends allowing contract modifications between unrelated parties without the need for fair market value testing where the modifications consist solely of IBOR-related modifications and do not include other contemporaneous modifications (as defined in Part II below). The ARRC believes that the best drafting approach would be to simply turn off the requirement in Proposed Section 1.1001-6(b)(2)(i) (the “fair market value requirement”) for contracts involving unrelated parties.
3. The ARRC believes it would be appropriate to limit the application of the fair market value requirement to related party contracts where other contemporaneous modifications are made along with IBOR-related modifications. If Treasury does not adopt this

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<sup>6</sup> See Consultation on Final Parameters for the Spread and Term Adjustments in Derivatives Fallbacks for Key IBORs, <https://www.isda.org/a/Ua0TE/Consultation-on-Parameters-for-Fallback-Adjustments.pdf>.

recommendation, the ARRC recommends turning off the application of the fair market value requirement to contracts between related parties (i) in the case of contracts that are substantially similar to contracts with unrelated parties or (ii) where at least one of the parties is subject to a financial regulatory regime.

4. The ARRC recommends that Treasury make additional changes to the fair market value requirement, including (i) adding a new financial accounting safe harbor providing that the fair market value requirement would be deemed to be satisfied if under generally accepted accounting principles (“GAAP”) or the international financial reporting standards, as applicable, an IBOR-related modification does not result in a deemed extinguishment of the contract for financial accounting purposes; (ii) expanding the safe harbor under Proposed Section 1.1001-6(b)(2)(ii)(A) to provide that, in a case where the parties are modifying fallback provisions as contemplated by Proposed Section 1.1001-6(a)(3), the safe harbor is met where the fallback provision uses a historic average of rates that is measured at the time when the fallback provision’s spread calculation date occurs as opposed to when the contract is amended; (iii) providing that the fair market value requirement can be met by valuing only the elements of the contract that are changed and not the contract as a whole; and (iv) eliminating the consistency requirement from Proposed Section 1.1001-6(b)(2)(i).

*Proposed Section 1.1001-6(b): Amend the definition of a qualified rate*

5. The ARRC recommends clarifying that the existence of a waterfall or hierarchy does not preclude a fallback provision from meeting the qualified rate requirement, even if one or more of the lower steps in the waterfall does not expressly require a qualified rate.
6. The ARRC recommends clarifying that if a fallback provision initially transitions into one qualified rate and automatically switches to a different qualified rate once the second such rate is available or within a reasonable time thereafter, these two rates would be treated as a single qualified rate for purposes of Proposed Section 1.1001-6 and no taxable exchange would occur upon the change of the reference rate from the first qualified rate to the second qualified rate.
7. The ARRC recommends expanding the parenthetical in Proposed Section 1.1001-6(b)(1)(ix) to include “any group endorsed or convened by the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of New York” in order to ensure that any rate it recommends as a replacement for an IBOR-referencing rate would be a qualified rate enumerated in Proposed Section 1.1001-6(b)(1).

## **B. Recommendations Regarding One-Time Payments**

8. The ARRC reiterates the request it made in the ARRC June 2019 Supplemental Submission to expand the application of the sourcing rule of Section 1.863-7 to all derivative contracts as defined in Section 1.1001-4(b)(3) solely with respect to one-time payments made in connection with the transition from an IBOR to an alternative reference rate.

9. The ARRC recommends allowing market participants to take positions with respect to the timing of recognition of a one-time payment that are reasonable in light of the nature of, and tax accounting principles applicable to, the instrument being modified, provided that they take a consistent approach in similar circumstances.

### **C. Recommendations Regarding Integration and Hedging Transaction Rules**

10. The ARRC recommends clarifying that Proposed Section 1.1001-6(c) applies to fallback provisions, and that differences between fallback provisions in different components of an integrated transaction would not cause a leg-out of an integrated transaction under Sections 1.1275-6 or 1.988-5, a disposition or termination of one or more legs of a transaction subject to the hedge accounting rules of Section 1.446-4 or a termination of a qualified hedge under Section 1.148-4(h).
11. The ARRC would be supportive were Treasury to provide that there would be no leg-out of an integrated transaction if the changes to the individual components to remove an IBOR-referencing rate are covered by Proposed Section 1.1001-6, even if the resulting debt instrument and hedge would no longer satisfy the requirements for integration if tested after the changes occur.
12. The ARRC also recommends that Treasury provide guidance facilitating transitional hedging under the integration rules. For example, Treasury could provide guidance giving taxpayers flexibility to enter into (and potentially terminate) additional hedge positions designed to address rate mismatches arising from the IBOR discontinuation in a manner that avoids a leg-out.

### **D. Recommendations Regarding the OID Regulations**

13. The ARRC recommends clarifying that Proposed Section 1.1275-2(m) applies to fallback provisions that initially transition into one qualified rate and later automatically switch to a different qualified rate once the second rate is available or within a reasonable time thereafter.

### **E. Recommendations Regarding Fixed Investment Trusts**

14. The ARRC recommends that Treasury provide that neither the modifications described in Proposed Section 1.1001-6(a)(1)–(3), together with associated alterations defined in Proposed Section 1.1001-6(a)(5), nor the operation of a fallback provision will cause a Variable Strip Trust (as defined in Part VI below) to fail to be classified as an “investment trust” within the meaning of Section 301.7701-4(c).

### **F. Recommendations Regarding Fast-Pay Stock**

15. The ARRC recommends that Treasury clarify that neither (i) a modification described in Proposed Sections 1.1001-6(a)(1)–(3) or (5) nor (ii) a change in rate that occurs by operation of a fallback provision in anticipation of or resulting from an IBOR becoming unavailable or unreliable will not be considered a “significant modification” or a

“significant change in the relevant facts and circumstances” for purposes of Section 1.7701(l)-3(b)(2).

## **G. Recommendations Regarding Potential Changes in Method of Accounting**

16. The ARRC recommends that Treasury confirm that the change of a discount rate used for purposes of Section 475 valuations of securities from an IBOR to another rate, either in anticipation of the discontinuation of such IBOR or at the time at which the IBOR no longer is available, does not constitute a change of accounting method.

## **II. Recommendations Regarding Proposed Section 1.1001-6**

The Proposed Regulations provide that replacing an IBOR in a debt instrument or non-debt contract<sup>7</sup> with a “qualified rate” or modifying or adding a fallback provision to include a qualified rate as a fallback to a rate referencing an IBOR,<sup>8</sup> together with any associated

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<sup>7</sup> For simplicity, this letter refers generally to debt instruments and non-debt contracts as “instruments” or “contracts” and to changes to those instruments or contracts as “alterations” or “modifications.”

<sup>8</sup> The rule addressing fallback provisions applies also to the substitution of a qualified rate for a fallback rate that references an IBOR. Prop. Reg. § 1.1001-6(a)(3).

While the Proposed Regulations are clearly intended to apply, subject to the conditions they impose, to bilateral agreements between parties to replace an IBOR with a qualified rate or to amend a fallback provision, they do not state explicitly how they are intended to apply to the replacement of an IBOR pursuant to the operation of a fallback provision. The Proposed Regulations are sufficiently broad under their terms to apply to such a replacement, but parties may not need to rely on the Proposed Regulations in many cases.

In the case of a fallback provision that operates pursuant to formulaic contractual terms, such as those recommended by ISDA and the ARRC for floating rate notes (except for the last discretionary step in such recommended fallback waterfall, which is discussed in the paragraph below), the ARRC believes that, because the replacement occurs by operation of the terms of the instrument, the replacement should not be a taxable event without regard to the Proposed Regulations. See Section 1.1001-3(c)(1)(ii) (changes occurring by operation of the terms of a debt instrument are generally not treated as modifications). This conclusion should not change even if a person (e.g., an administrative agent or a calculation agent, which may be one of the parties) has limited discretion in implementing the replacement pursuant to standards set forth in the fallback provision. Cf. Notice 2015-74, 2015-46 I.R.B. 663, which defines “discretion” to exclude “the exercise [of] routine judgment in the administration of the rules. . . .” It would be helpful for Treasury to confirm—for example, by including a statement in the preamble to the final regulations—that the implementation of a formulaic fallback provision in either a debt instrument or a non-debt contract would not be viewed as an exchange under Section 1001. Because the operation of such a fallback provision happens automatically for the most part, requiring the parties to apply the tests in Proposed Section 1.1001-6 at that time would be impractical in many cases. And because the operation of the fallback provision is not within the parties’ control, whether the modification met the fair market value test, for example, could be somewhat random because it would depend on circumstances at the time of activation of the fallback provision.

Certain other fallback provisions operate in a manner that is somewhat less prescriptive and relies on a calculation agent or other party to determine a market or industry-standard rate. For example, the last step in the ARRC fallback provisions for floating rate notes requires the issuer or its designee to select the replacement rate “[giving] due consideration to any industry-accepted rate of interest as a replacement for the then current Benchmark for U.S. dollar denominated floating rate notes at such time” and spread adjustment “giving due consideration to any market-accepted conventions for such spread adjustment.” Because widely accepted industry standards, such as the ISDA Definitions, are likely to develop, the ARRC believes that, although the matter is less clear, the replacement of

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alterations or modifications within the meaning of Proposed Section 1.1001-6(a)(5), is not treated as an exchange for purposes of the relevant provisions of Section 1001.<sup>9</sup> This letter refers generally to changes of this type as “IBOR-related modifications.” The ARRC supports Treasury’s decision to apply the Proposed Regulations broadly to both debt instruments and non-debt contracts, including preferred stock, and to rate modifications as well as modifications to fallback provisions.

An “associated” alteration or modification means any alteration of an instrument that is “associated with” the alteration 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 implement that replacement or inclusion. An associated alteration or modification may be (i) a technical, administrative, or operational alteration or modification or (ii) 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.<sup>10</sup>

By contrast, Proposed Section 1.1001-6(a)(4) provides that other contemporaneous modifications or alterations to the instrument (“other contemporaneous modifications”) will be tested independently under applicable Section 1001 principles. Any IBOR-related modifications

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an IBOR under these less prescriptive fallback provisions should also be viewed as “pursuant to the terms” of the instrument and therefore not a taxable event under Section 1001. Should Treasury disagree with this conclusion, it would be important for parties to be able to rely on the Proposed Regulations in these circumstances, which in turn highlights the importance of applying the fair market value requirement in an administrable way. For these reasons, in addition to those further explained in Part II of in this letter, the ARRC urges Treasury to consider our requests discussed in Part II.B and II.C.

<sup>9</sup> Prop. Reg. § 1.1001-6(a)(1)–(3). In the syndicated loan market, it is common for IBOR-based loans to provide for a mechanism to enable the parties to substitute a successor rate for the IBOR rate by bilateral agreement. Under these mechanisms, the borrower and administrative agent will propose a successor rate (e.g., SOFR), and the lenders have a window of time in which to object (typically five business days). Absent any objection, the proposed successor rate will become the new reference rate for the loan for all lenders. If the “window” does not go into effect until the IBOR has become discontinued, the loan may pay a fallback rate (for example, the “prime” rate made publicly available by the administrative agent) for the period of time until the successor rate is determined.

In this situation, the successor rate could be viewed as replacing the temporary fallback rate rather than the original IBOR rate under the terms of the loan agreement, in which case the modification would not be eligible for the benefits of Proposed Section 1.1001-6. The ARRC believes that Proposed Section 1.1001-6 should apply to this situation, because the successor rate is really replacing the original IBOR that applied to the loan, rather than the temporary fallback rate that applied upon the IBOR discontinuation. Given the widespread nature of these provisions in the syndicated loan market, it would be helpful for Treasury to clarify that Proposed Section 1.1001-6 applies in these circumstances.

A similar situation may arise in the context of an IBOR-based debt instrument (or other contract) that has defaulted to a fixed fallback rate when the IBOR has been discontinued. In this situation, the parties should be able to use Proposed Section 1.1001-6 to transition the instrument to a replacement qualified rate, even though this replacement occurs after the IBOR discontinuation and at a time when the actual payments are no longer based on the IBOR.

<sup>10</sup> Prop. Reg. § 1.1001-6(a)(5).

are treated for this purpose as if they are part of the unmodified instrument, and therefore are not taken into account in measuring the economic significance of the other contemporaneous modifications. The Proposed Regulations provide, as an example of an other contemporaneous modification, an increase to the interest rate on a debt instrument to account for a decrease in the issuer's credit since issuance.

The definition of "qualified rate" is quite broad and includes qualified floating rates, as well as certain enumerated rates.<sup>11</sup> The ARRC believes that the categories of acceptable replacement rates should be broad, and therefore endorses Treasury's approach in this regard.

However, in order for a replacement rate to be a qualified rate it must also meet the fair market value requirement, which requires the fair market value of the modified contract after the IBOR-related modifications (including any one-time payment) to be substantially equivalent to the fair market value of the contract before the IBOR-related modifications.<sup>12</sup> In determining fair market value, the parties may take into account any reasonable, consistently applied valuation method, which may, but need not be, based on past or projected values of the relevant rates.<sup>13</sup> The Proposed Regulations contain two safe harbors under which replacement rates are deemed to meet the fair market value requirement: the historic average rate safe harbor and the arm's length safe harbor (together, the "FMV safe harbors").<sup>14</sup>

In the preamble to the Proposed Regulations (the "Preamble"), Treasury states that the fair market value requirement is intended to limit IBOR alterations or modifications to those that are necessary to replace the IBOR in the terms of the contract with a new reference rate. The Preamble also states that Treasury recognizes that it may be difficult to determine the value of debt instruments and non-debt contracts with precision, and therefore the FMV safe harbors are provided to ease compliance.<sup>15</sup>

Since the ARRC April 2019 Letter, a number of important rule-making bodies, in addition to Treasury, have issued guidance that is intended to enable parties to transition legacy IBOR contracts without adverse consequences. These include the Financial Accounting Standards Board (the "FASB")<sup>16</sup> as well as the U.S. Commodity Futures Trading Commission (the "CFTC") and other financial regulators.<sup>17</sup> In particular, the final FASB relief, which is discussed further

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<sup>11</sup> Prop. Reg. § 1.1001-6(b)(1).

<sup>12</sup> Prop. Reg. § 1.1001-6(b)(2)(i). Although the fair market value requirement is contained within the qualified rate definition, this letter generally refers separately to the fair market value requirement and the general portion of the qualified rate definition contained in Proposed Section 1.1001-6(b)(1), i.e., the general rule regarding the types of rates that can be qualified rates.

<sup>13</sup> Prop. Reg. § 1.1001-6(b)(2)(i).

<sup>14</sup> Prop. Reg. § 1.1001-6(b)(2)(ii).

<sup>15</sup> See Preamble, Explanation of Provisions, Part 1.A.

<sup>16</sup> See *infra* note 28 and accompanying text.

<sup>17</sup> CFTC staff has issued regulatory relief allowing for IBOR-related modifications to swaps without the loss of the legacy status of the swap. Absent specific relief, certain modifications made to certain legacy swaps may (...continued)

below, is expected to confirm that certain IBOR-related alterations to a contract will not cause a deemed extinguishment of the contract, without requiring a party to perform qualitative or quantitative testing. While the ARRC appreciates that financial accounting and tax principles can differ, it believes that a tax rule that is broadly consistent in ordinary course circumstances with financial accounting rules will allow for a simpler and faster transition of large numbers of contracts, helping to minimize potential market disruption. The ARRC also notes that, to the extent financial accounting and tax treatment differ, even if only temporarily, additional complexity would result from market participants having to track the differences at a contract level and account for them as deferred income taxes for financial accounting purposes. As a result, certain of the recommendations below are aimed at greater alignment with the expected final FASB relief.

The discussion in this Part II groups the ARRC's recommendations into three categories. Part II.A discusses a specific recommendation for the ARRC fallback provisions, the ISDA fallback provisions and substantially similar provisions. Part II.B discusses the fair market value requirement and its application to unrelated parties and related parties and suggests related revisions. Part II.C discusses the qualified rate definition (separate from the fair market value requirement) and makes certain recommendations.

#### **A. Recommendation Regarding a “Fast Track” Exemption for Adoption of the ARRC or ISDA Fallback Provisions or Substantially Similar Fallback Provisions**

This Part II.A recommends that Treasury add a rule to Proposed Section 1.1001-6(a) that would treat a modification to a contract to adopt the ARRC fallback provisions, the ISDA fallback provisions, or provisions substantially similar to either the ARRC fallback provisions or the ISDA fallback provisions (“Substantially Similar Fallback Provisions”), as being within the scope of Proposed Section 1.1001-6 and therefore not giving rise to a tax event under Section 1001. This recommendation is intended to provide a streamlined, or “fast track,” process for taxpayers to incorporate standardized market-wide fallback provisions without having to go

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subject those swaps to additional regulatory rules, including the swap margin requirement, the central clearing requirement, additional documentation requirements and trade execution requirements. To facilitate an orderly market-wide transition away from IBORs, the CFTC staff relief concluded that amendments to swaps necessary to accomplish the IBOR transition should not cause a loss of legacy status. Moreover, recognizing that replacements could be carried out using a variety of legal mechanisms, the CFTC staff relief has recognized several possible forms of modifications, including 1) amending the fallback provision through adhering to protocols or bilateral amendments, 2) replacing the IBOR-related rate with a replacement rate effected bilaterally between swap parties, and 3) entering into new swaps that replace the IBOR basis of a portfolio with an alternative reference rate without amending swaps themselves. See Press Release, Comm. Fut. Trading Comm'n, CFTC Provides Relief to Market Participants Transitioning Away from LIBOR (Dec. 18, 2019), <https://www.cftc.gov/PressRoom/PressReleases/8096-19>.

Similarly, five other financial regulators, including the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Agency, have collectively proposed to allow certain technical amendments to legacy swaps without altering their legacy status under their respective regulatory regimes. See Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59,970 (proposed Nov. 7, 2019) (to be codified at 12 C.F.R. pts. 45, 237, 349, 624, 1221), <https://www.occ.treas.gov/news-issuances/federal-register/2019/84fr59970.pdf>.

through the tests in Proposed Section 1.1001-6(b), and is consistent with the guidance sought by the ARRC relating to the Protocol.

A crucial element of the market response to IBOR discontinuation is the modification by market participants of legacy IBOR-based contracts to incorporate robust fallback provisions that will transition those contracts to an appropriate replacement rate on or prior to IBOR discontinuation.<sup>18</sup> As a result, the ARRC and ISDA have devoted significant resources to developing robust fallback recommendations and facilitating these modifications.

Between April and November of 2019, the ARRC published recommended fallback provisions for five categories of debt instruments: adjustable rate mortgages, bilateral business loans, floating rate notes, securitizations and syndicated loans. Market participants have used these fallback provisions for newly issued debt instruments<sup>19</sup> and may seek to modify legacy debt instruments to incorporate these fallback provisions or similar ones. The ARRC's process for developing these fallback provisions, and other background detail, is discussed in Appendix I. ISDA is expected to publish fallback provisions for derivative contracts in 2020. The ARRC December 2019 Letter described the expected ISDA fallback provisions and background regarding their development.

The ARRC encourages market participants to use the ARRC-recommended fallback provisions for newly issued debt instruments, and believes that market participants will seek to modify their existing debt instruments to include substantially similar provisions.<sup>20</sup> Similarly, with respect to derivative contracts, the ARRC encourages broad adherence to the Protocol or incorporation of substantially similar provisions through bilateral amendments.<sup>21</sup> The wide

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<sup>18</sup> See John C. Williams, President & CEO, Fed. Res. Bank of N.Y., Remarks at the Securities Industry and Financial Markets Association, New York City: 901 Days (July 15, 2019), <https://www.newyorkfed.org/newsevents/speeches/2019/wil190715> ("If companies are going to use LIBOR, they need to start including robust fallback language in the contract, so that if LIBOR ceases to exist, chaos does not ensue."); *Member Spotlight, Rep. David Scott (D, GA-13)*, STRUCTURED FIN. COAL., <https://structuredfinance.org/wp-content/uploads/2019/12/Rep.-David-Scott-member-spotlight-10.28.19.pdf> (last accessed Feb. 20, 2020) ("It is encouraging to see the use of fallback language and increased uptake of SOFR for new contracts, but addressing outstanding contracts based on Libor will be critical in minimizing disruption . . . Congress should look at different proposals to address this risk and thus encourage a more [expeditious] transition, including a safe harbor from liability to encourage a change in legacy contracts.").

<sup>19</sup> For example, Ford Motor Credit announced that it had launched an auto loan securitization with a floating rate tranche adopting the ARRC recommended fallback language. See *ARRC Welcomes Ford Motor Company Use of Recommended Securitization for Auto Loans*, NEWYORKFED.ORG (June 21, 2019), [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Ford\\_ARRC\\_fallback\\_language\\_release.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Ford_ARRC_fallback_language_release.pdf).

<sup>20</sup> See *LIBOR-SOFR Transition*, FANNIEMAE.COM (Nov. 15, 2019), <https://www.fanniemae.com/content/news/libor-sofr-transition> (Fannie Mae's adoption of fallback language recommended by ARRC for ARMs) and *Freddie Mac to Use ARRC Recommended Fallback Language for Single-Family Adjustable Rate Mortgages*, FREDDIEMAC.GCS-WEB.COM (Nov. 15, 2019), <https://freddiemac.gcs-web.com/news-releases/news-release-details/freddie-mac-use-arrc-recommended-fallback-language-single-family>.

<sup>21</sup> Some commentators believe that cash market participants are likely to adopt the ISDA protocol into their loan contracts as well. See Natasha Rega-Jones, *Libor Limbo: Loan Market Fallback Language Upends Lenders*, (...continued)

adoption of the ARRC and ISDA fallback provisions or Substantially Similar Fallback Provisions will help to achieve uniformity across similar types of contracts and reduce the risk of market disruption following the cessation of IBORs. As a result, there will be significant benefit to the IBOR transition process if parties are freely able to modify their legacy contracts to include the ARRC fallback provisions, the ISDA fallback provisions or Substantially Similar Fallback Provisions.

The final FASB relief is expected to provide that the addition of contractual fallback terms, or the amendment of existing contractual fallback terms, to be consistent with or substantially similar to fallback terms recommended by a regulator or by a private-sector working group convened by a regulator (e.g., the ARRC) will be presumed to be related to reference rate reform and, therefore, the modified contract is considered to be a continuation of the existing contract without further qualitative or quantitative testing.

The ARRC believes that modifications made to incorporate fallback provisions recommended by the ARRC or ISDA, or Substantially Similar Fallback Provisions, are unlikely to generate consequences that conflict with Treasury's tax policy objectives. The ARRC outlined its reasoning to this effect in detail in the ARRC ISDA Submissions with respect to the ISDA fallback provisions, and believes the same reasoning applies to the ARRC fallback provisions. These fallback provisions result from market-wide consultations and reflect input from regulators, trade associations, exchanges and other intermediaries, and buy-side and sell-side market participants. As a result, they reflect market-wide standards rather than individually negotiated provisions.

Consistent with the discussion in the ARRC ISDA Submissions, some market participants may adopt these fallback provisions with some differences to reflect their specific situations.<sup>22</sup> The ARRC reiterates its view expressed in those submissions that guidance

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RISK.NET (Feb. 6, 2020), <https://www.risk.net/derivatives/7401896/libor-limbo-loan-market-fallback-language-upends-lenders>.

<sup>22</sup> For example, the ARRC recommendations for fallback language in floating rate notes explicitly encourage market participants to adjust the definition of Compounded SOFR "to the extent that they would use specific conventions for this rate regardless of any ARRC recommendation (e.g., if issuers and investors of a particular issuance are certain they would fall back to a Compounded SOFR with a two-day 'lookback' period, that should be explicitly stated using the language in brackets at the end of the definition of Compounded SOFR)." ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ISSUANCES OF LIBOR FLOATING RATE NOTES, NEWYORKFED.ORG 15 (Apr. 25, 2019), [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN\\_Fallback\\_Language.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN_Fallback_Language.pdf). As another example, although the ARRC recommended fallback language for securitizations includes a waterfall that references term SOFR as the first step, the ARRC recognized that "because standard derivatives are not expected to reference a forward-looking term rate, issuers in the cash market who execute hedges may prefer to remove Term SOFR . . . in order to fall back to Compounded SOFR" and that "other conforming changes may also be needed at the time a fallback is activated in order to maintain alignment with hedges." See ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ISSUANCES OF LIBOR SECURITIZATIONS, NEWYORKFED.ORG 15 (May 31, 2019), [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization\\_Fallback\\_Language.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization_Fallback_Language.pdf). For a discussion of Term SOFR and Compounded SOFR, see *infra* notes 41 and 42.

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should be flexible enough to accommodate such substantially similar modifications, as it believes that the adoption of robust market-wide fallback provisions as a general matter is highly desirable and bilateral modifications to the standard fallback provisions may be necessary in many situations.

While a modification to a contract to incorporate the ARRC or ISDA fallback provisions or Substantially Similar Fallback Provisions can potentially meet the requirements of Proposed Section 1.1001-6, there are technical and practical questions that present barriers to such modifications. These issues are addressed in the ARRC ISDA Submissions and described in more detail below in the discussion of the fair market value requirement specifically and the qualified rate definition more generally.

Accordingly, consistent with the ARRC ISDA Submissions, the ARRC recommends adding a rule to Proposed Section 1.1001-6(a) stating that, if the only modifications to a contract are ones incorporating the ARRC fallback provisions, the ISDA fallback provisions or Substantially Similar Fallback Provisions, such modifications will not be treated as a taxable event under Section 1001.<sup>23</sup> The ARRC believes it would greatly facilitate a smooth IBOR

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Additional examples were also provided in the ARRC ISDA Submissions. For example, if the Amended Definitions do not include a pre-cessation trigger event (as defined in the ARRC December 2019 Letter), it is possible that parties will want to include one through bilateral amendment. See *LCH's Position in respect of Pre-cessation Triggers in relation to SwapClear*, LCH.COM (Dec. 20, 2019), <https://www.lch.com/membership/ltd-membership/ltd-member-updates/lchs-position-respect-pre-cessation-triggers-relation> (noting that LCH Group will consult with market participants on adopting a pre-cessation trigger because it would be challenging to clear swaps linked to a non-representative IBOR from a risk-management and regulatory perspective). As another example, in order to accommodate counterparty requests, market participants may enter into substantially similar bilateral amendments that are tailored to the counterparty's particular documents or scope of transactions.

<sup>23</sup> This letter focuses primarily on providing an exemption for the fallback provisions recommended by the ARRC and ISDA given their expected market-wide adoption. However, there may be other fallback provisions selected, endorsed or recommended by other groups (including a central bank, reserve bank, monetary authority or similar institution), particularly for IBORs in currencies other than the USD. It would further facilitate a smooth IBOR transition for Treasury to grant relief for those fallback provisions as well.

Relatedly, this recommendation may, if adopted, also address contractual modifications that arise as a result of legislation to address existing LIBOR-linked contracts that either lack contractual provisions to deal with the end of LIBOR or have contractual provisions that do not effectively address a permanent cessation of LIBOR. In its November 2019 meeting, the ARRC determined that it was appropriate to discuss such potential legislation with relevant New York State authorities. See ARRC MINUTES FOR THE NOVEMBER 15, 2019 MEETING, NEWYORKFED.ORG., <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2019/ARRC-Minutes-Nov-2019.pdf>. The ARRC is discussing with such authorities the potential for legislation that would require the application of an ARRC-recommended SOFR rate and spread adjustments in all contracts governed by New York law across all asset classes (i) on a mandatory basis for contracts that are either silent on fallback provisions or use IBOR-based fallbacks and (ii) on a permissive basis for contracts with discretionary fallback provisions, and publicly released its proposal for New York State legislation on March 6, 2020. See *Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition*, NEWYORKFED.ORG., <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2020/ARRC-Proposed-Legislative-Solution.pdf>; Patrick Dolan & Kathleen Scott, *The LIBOR Transition - Potential New York State Legislation*, REGULATIONTOMORROW.COM (Dec. 16, 2019), <https://www.regulationtomorrow.com/us/the-libor-transition-potential-new-york-state-legislation/>. The (...continued)

transition to provide this streamlined process that promotes the incorporation of robust market fallback provisions. If the parties to a contract make any other IBOR-related modifications, such as IBOR-related modifications, together with the modification to a contract to incorporate the ARRC fallback provisions, the ISDA fallback provisions or Substantially Similar Fallback Provisions, would be tested under general Proposed Section 1.1001-6 requirements. If the parties to a contract make any other contemporaneous modifications, those would be tested under general Section 1001 principles.

As discussed further below, the ARRC also recommends specific revisions to the qualified rate definition in order to facilitate contract modifications to replace or incorporate fallback provisions that are not substantially similar to the ARRC or ISDA fallback provisions. Those recommendations are in addition to, rather than alternatives to, the recommendation in this section.<sup>24</sup>

## **B. Recommendations Regarding the Fair Market Value Requirement**

The ARRC acknowledges Treasury's concern regarding the potential use of the Proposed Regulations by taxpayers to make contractual modifications that are not directly related to the replacement of an IBOR-referencing rate, and appreciates the elements of flexibility contained in the section of the Proposed Regulations addressing the fair market value requirement. Nonetheless, the ARRC believes that the fair market value requirement, as currently drafted, will unduly constrain the ability of market participants to accomplish ordinary-course IBOR-related modifications. Moreover, the ARRC believes that the policy objectives underpinning the fair market value requirement will still be accomplished if it applies to a narrower scope of transactions.

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ARRC has approached New York State authorities because a significant portion of LIBOR-based contracts are governed by New York law, but other states may also enact IBOR-related legislation.

Although the ARRC believes that a modification to the legal rights and obligations of parties to a debt instrument resulting from a change in the governing law should be viewed as "an alteration of a legal right or obligation that occurs by operation of the terms" under Section 1.1001-3(c)(1)(ii), and thus not a modification for purposes of Section 1001, there is limited authority in this area. In addition, because there are no comprehensive regulations addressing the treatment under Section 1001 of non-debt instruments, the analysis for those instruments is even less clear. Therefore, the adoption of the ARRC's recommendation discussed in this part would likely provide an ancillary benefit of addressing the consequences to a contract of the IBOR legislation sought by the ARRC, if enacted. However, because legislation (whether enacted by New York or another jurisdiction) may vary from the legislation sought by the ARRC, it would be helpful for Treasury to clarify (such as in the preamble to the final regulations) that a modification to legal rights and obligations relating to a contract pursuant to a change in applicable law governing the contract is not a modification for purposes of Section 1001.

<sup>24</sup> If Treasury does not adopt the general recommendation in this Part II.A regarding the ARRC and ISDA fallback provisions and Substantially Similar Fallback Provisions, it should adopt a safe harbor to the fair market value requirement for modifications to adopt such a fallback provision along with the recommendations in Part II.C relating to the qualified rate definition as it applies to fallback provisions.

The ARRC appreciates Treasury's efforts to ease compliance by means of the FMV safe harbors and very much agrees with Treasury's statement in the Preamble that safe harbors will facilitate IBOR transition activity. As discussed further below, however, in many cases the FMV safe harbors are not clearly available to taxpayers; as a result, taxpayers must often meet the general fair market value requirement. Although the general fair market value requirement is clearly designed to be flexible, in many circumstances there may be either constraints on taxpayers' ability to rely on it or else impracticalities in applying it.

By imposing a contract-specific compliance burden, the fair market value requirement would impair the ability of market participants, including financial institutions, to transition massive numbers of legacy contracts in advance of IBOR discontinuation.<sup>25</sup> Given the scope of the task at hand as well as the limited time in which to accomplish it, it is vital that these parties be able to adopt streamlined processes to migrate their legacy contracts. To comply with a contract-level fair market value testing requirement, market participants would have to design, program and test new reporting capabilities for each of their operating systems housing impacted contracts, burdening the ability of a wide range of parties to effect an orderly transition.

One other practical issue with the general fair market value requirement arises from its dependence on the value of the contract after the modification. In order to agree to an IBOR-related modification, parties will need, in advance of agreeing to the modification, a high degree of confidence that the Proposed Regulations will apply. In the case of instruments that are actively traded, such as certain debt instruments or preferred stock, the risk that the instrument could trade up or down shortly after the modification could deter the parties from making the necessary changes because of uncertainty about whether the fair market value requirement will be met. As a result, the Proposed Regulations may, in practice, be difficult to apply to such instruments. In other contexts, such as in the case of complex, non-traded contracts, valuation may be costly and difficult.

The ARRC believes that the vast majority of situations where parties seek to replace an IBOR-referencing rate or modify a fallback provision involve a low or nonexistent likelihood of abuse. Most such modifications will involve unrelated parties acting at arm's length for the limited purpose of addressing IBOR discontinuation. For modifications to fallback provisions, many will incorporate standard market provisions, such as those proposed by the ARRC and ISDA, as discussed above, and their ultimate effect on rates in the contract will be unknown at the time of the modification because fallback provisions are forward looking. Finally, as the IBOR transition is a one-time event with limited duration, risk of harm to the government is inherently limited. For these reasons, the ARRC believes that the practical burden of a broadly scoped fair market value requirement outweighs the benefit of the requirement.

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<sup>25</sup> Many taxpayers have a vast number of legacy contracts to modify. For example, a typical mid-sized regional bank may need to amend multiple thousands of legacy loans and non-debt contracts spanning multiple operating systems. The number of contracts that a large financial institution may need to amend can be exponentially larger, potentially in the tens or hundreds of thousands, and may involve a more expansive web of operating systems.

In recognition of similar principles, the FASB's proposed relief, issued in September 2019 and expected to be finalized in March 2020,<sup>26</sup> allows entities to make certain IBOR-related modifications to contracts without the need for further qualitative or quantitative testing. Under current GAAP, modifications to a contract must undergo a quantitative or qualitative assessment to determine whether the modifications result in extinguishment of the contract.<sup>27</sup> Given the sheer volume of contracts that will be modified, this assessment could be costly and burdensome for IBOR-related modifications. Therefore, to facilitate the IBOR transition, the FASB has issued relief from this requirement whereby an entity may conclude, without the qualitative or quantitative test, that changes "related to the replacement of the reference rate" do not result in an extinguishment of the contract.<sup>28</sup> As the FASB explained in the Exposure Draft, it anticipates that these amendments "will reduce or mitigate the costs and complexity of accounting for contract modifications and hedging relationships affected by reference rate reform" and, given the pervasiveness of IBOR-based contracts, such relief "would provide cost savings to a wide array of financial statement preparers."<sup>29</sup> The FASB further stated that the general principle underlying these amendments is to capture the economic substance of contract modifications resulting from the IBOR transition, and concluded that existing methods under GAAP could be burdensome and could result in financial reporting that is not reflective of an entity's business strategy or intent.<sup>30</sup> The ARRC believes that the rationale for, and general

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<sup>26</sup> The ARRC will provide the finalized FASB relief to Treasury in a supplemental submission once it is publicly released.

<sup>27</sup> For example, as described in ASC 470-50-40-10 for borrowers and ASC 310-20-35-11 for lenders, changes to the terms of a debt instrument will cause it to be deemed extinguished for purposes of U.S. GAAP if the present value of projected future cash flows changes by ten percent or more as a result of such change. See EITF ABSTRACTS: DEBTOR'S ACCOUNTING FOR A MODIFICATION OR EXCHANGE OF DEBT INSTRUMENTS, Issue No. 96-19, FASB.ORG (2010), [https://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1218220144569&acceptedDisclaimer=true](https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220144569&acceptedDisclaimer=true).

<sup>28</sup> The Proposed Accounting Standards Update ("ASU") released by the FASB on September 5, 2019 relating to Reference Rate Reform is available at <https://asc.fasb.org/imageRoot/08/120524608.pdf> (the "Exposure Draft"). Under the Exposure Draft, certain changes are presumed to be related to the replacement of the reference rate, including (a) changes to the reference interest rate index; (b) addition of or changes to a spread adjustment for the difference between an existing reference rate and the replacement reference rate; (c) changes to the reset period, reset dates, repricing calculation and similar administrative or technical items; (d) changes to the strike price of an existing embedded interest rate option; and (e) addition of an out-of-the-money interest rate floor or cap. See Exposure Draft, paragraph 848-20-15-5 at 13–14, <https://asc.fasb.org/imageRoot/08/120524608.pdf>.

The International Accounting Standards Board ("IASB") is considering providing similar relief under the International Financial Reporting Standards ("IFRS"). Based on a recent staff paper presented at a public meeting of the IASB, the staff is considering examples of modifications that would not result in substantial modifications, including (i) modifications to replace the current interest rate benchmark with an alternative benchmark rate that is economically equivalent; and (ii) modifications to the timing and frequency with which the benchmark rate is reset. The staff emphasized that these examples are not exhaustive. See *IBOR Reform—Phase 2: Classification and measurement—modification of financial instruments* (Int'l Fin. Reporting Standards, IASB meeting, Staff Paper 14A, Oct. 2019), <https://www.ifs.org/-/media/feature/meetings/2019/october/iasb/ap14a-ibor.pdf>.

<sup>29</sup> See Exposure Draft, BC11–12 at 43–44, <https://asc.fasb.org/imageRoot/08/120524608.pdf>.

<sup>30</sup> See Exposure Draft, BC13–14 at 44–45, <https://asc.fasb.org/imageRoot/08/120524608.pdf>.

principles underlying, the FASB relief relating to the IBOR transition are aligned with those of the Proposed Regulations, and reiterates that, to the extent financial accounting and tax treatment, even if only temporarily, additional complexity would result from market participants having to track the differences at a contract level and account for them as deferred income taxes for financial accounting purposes.

For these reasons, the ARRC recommends limiting the scope of the fair market value requirement as discussed in the sections below.

## **1. Unrelated Parties**

Where parties to a contract are unrelated and the modifications to that contract consist solely of IBOR-related modifications, i.e., modifications of the type described in Proposed Section 1.1001-6(a)(1)–(3) and (5) without regard to the fair market value requirement, the ARRC believes that the fair market value requirement is unnecessary. Therefore, the ARRC recommends exempting such transactions from the fair market value requirement, either expressly or by modifying the safe harbor for arm’s length negotiations in Proposed Section 1.1001-6(b)(2)(ii)(B) (the “arm’s length safe harbor”). If this recommendation is adopted, fair market value testing would not be required to be applied to the spread adjustment included in the qualified rate or any one-time payment within the meaning of Proposed Section 1.1001-6(a)(5).

As Treasury already recognized by providing the arm’s length safe harbor, parties to a contract acting at arm’s length will have little reason to give up contractual value gratuitously, and therefore the spread adjustment determined by the parties, when any one-time payment is taken into account, should reflect their mutual and offsetting objectives to preserve value.

The ARRC understands that Treasury is concerned that, without the fair market value requirement, third parties may renegotiate contractual terms to reflect, in particular, changes in one party’s credit spread. One can certainly imagine a party whose circumstances have changed, such as a borrower in financial stress, using IBOR-related negotiations to seek to make changes to other terms (for example, financial covenants) and the other party extracting a higher credit spread in exchange. In the absence of such unrelated changes, however, there would be little reason for even a financially troubled party to agree to a spread adjustment or one-time payment that has the effect of increasing the value of its obligation or otherwise shifting contractual value to its counterparty.

In situations where parties are making both IBOR-related modifications and other contemporaneous modifications, such as changing financial covenants or the maturity date, the fair market value requirement could continue to apply in order to establish the degree to which the spread adjustment or one-time payment reflects compensation for the other contemporaneous modifications as opposed to the IBOR-related modifications.<sup>31</sup> While the

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<sup>31</sup> The New York State Bar Association (“NYSBA”) has provided Treasury, in its December 27, 2019 comment letter on the Proposed Regulations, with a similar recommendation that the fair market value requirement should not apply where unrelated parties are making alterations reasonably necessary for the narrow purpose of facilitating the transition away from IBOR-referencing rates. See NEW YORK STATE BAR ASSOCIATION TAX SECTION (...continued)

ARRC believes that the distinction between IBOR-related modifications and such other contemporaneous modifications is fairly clear, Treasury could provide additional examples if it is concerned about ambiguity regarding these two categories.

Should Treasury determine that it agrees with the ARRC's general recommendation to allow IBOR-related modifications between unrelated parties without the need for fair market value testing, the ARRC believes that the best drafting approach would be to simply turn off the requirement in these circumstances. However, a similar result could be achieved through modifications to the arm's length safe harbor to clarify its operation in certain respects.

The arm's length safe harbor currently provides that the fair market value requirement is met where unrelated parties determine, based on bona fide arm's length negotiations, that the fair market values of a debt instrument or non-debt contract before and after an alteration or modification to replace an IBOR-referencing rate with a replacement rate are substantially equivalent.

Based on the current version of the arm's length safe harbor, it is unclear what procedural steps two contracting parties must take in order to determine that the fair market value of a contract is substantially unchanged. In particular, it is unclear whether the safe harbor calls for a minimum amount of actual negotiation or whether the mere fact of an agreement by two parties acting at arm's length is sufficient to establish that the value of the contract to each party has been preserved. Logically, it would seem that an agreement by two unrelated parties would establish the preservation of fair market value, whether or not there are observable negotiations.

In the case of widely held debt instruments or preferred stock, the nature of the relationship between the issuer and the holders means that there would not be direct negotiations between the parties or an agreement on fair market value of the instrument. Nonetheless, the willingness of the issuer and multiple holders to accept modifications would effectively establish that the parties do not believe that the modifications impair the value of the instrument to them. If anything, the fact that many holders are simultaneously agreeing to the same changes should be evidence that the changes are value-preserving. For these reasons, the requirement to engage in negotiations should be removed from the FMV safe harbor.

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REPORT NO. 1430, REPORT ON IBOR TRANSITION PROPOSED REGULATIONS (Dec. 27, 2019) [hereinafter "NYSBA Report"], Recommendation 1, [https://www.nysba.org/Sections/Tax/Tax\\_Section\\_Reports/Tax\\_Section\\_Reports\\_2019/Report\\_1430.html](https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/Report_1430.html).

If this proposal is adopted, Proposed Section 1.1001-6(a)(4), relating to other contemporaneous modifications, should be modified. It now describes a modification to an interest rate to account for credit deterioration as an other contemporaneous modification. However, if the proposal above is adopted, absent an other contemporaneous modification, rate changes and one-time payments alone would not be tested under the fair market value rule, and therefore a clearer example would be some other type of change (e.g., a deferral of the maturity date). If Treasury nonetheless retains concern that parties will make credit spread adjustments even in the absence of other contemporaneous modifications, it could draft the rule as a presumption that IBOR-related changes, including a spread adjustment and/or a one-time payment, are not taxable events unless evidence demonstrates that the parties renegotiated a portion of such spread adjustment or one-time payment to account for a shift in credit rating.

It is also not clear whether the parties are required to establish an actual valuation of the contract, or merely that the changes have not substantially affected the contract's value. If the parties were required to determine an actual valuation, the benefits of the arm's length safe harbor would be substantially diminished. Relatedly, it is unclear what documentation or other substantiation need be retained by market participants that rely on this safe harbor.

Therefore, if Treasury uses the arm's length safe harbor as a vehicle for limiting the application of the fair market value requirement to contracts between unrelated parties, the ARRC recommends (i) applying the safe harbor to any modification to a contract between unrelated parties to implement IBOR-related modifications, whether or not there are actual negotiations; (ii) clarifying that an actual valuation is not necessary; and (iii) requiring limited documentation or other administrative compliance. Consistent with the discussion above, Treasury could further specify that this safe harbor applies only where modifications to a contract consist solely of IBOR-related modifications and do not include other contemporaneous modifications.

## **2. *Related Parties***

While the vast majority of IBOR-based contracts, and therefore contract modifications, are likely to be between unrelated parties, related parties also engage in intercompany lending and derivative contracts that reference IBORs and may need to modify those contracts as well. Financial institutions, for example, often engage in intercompany derivative transactions for purposes of transferring a financial exposure arising from an unrelated party transaction to an affiliate that provides centralized hedging for the group. In certain circumstances the tax consequences of a deemed termination of a related party transaction will be limited, but in others they could be meaningful (e.g., where a reissued swap is deemed to be treated as a loan for tax purposes and therefore, for example, gives rise to base erosion payments).

While related parties may not have the same economic incentives as unrelated parties to transact on arm's-length terms, they often have regulatory restrictions and other reasons to avoid gratuitous transfers of value between them. For example, related parties would generally be subject to Section 482, under which any such gratuitous value transfer would be treated for tax purposes in an appropriate manner.<sup>32</sup> Therefore, while the ARRC acknowledges that the arguments outlined in the previous section for unrelated party contracts are not necessarily applicable to the related party context, the ARRC also believes that there are meaningful reasons why related parties making IBOR-related modifications will choose to adopt market-standard fallback modifications and/or rate changes designed to preserve the economic relationships in the legacy contracts. Accordingly, the ARRC believes it would be appropriate to limit the fair market value requirement as it applies to related party contracts to situations in which other contemporaneous modifications are made along with IBOR-related modifications.

If Treasury does not adopt this recommendation, the ARRC recommends turning off the application of the fair market value requirement to contracts between related parties (i) in the case of contracts that are substantially similar to contracts with unrelated parties or (ii) where at

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<sup>32</sup> Treas. Reg. § 1.482-1(g)(3)(i); see, e.g., Rev. Rul. 69-630, 1969-2 CB 112.

least one of the parties is subject to a financial regulatory regime. With respect to derivative contracts or debt instruments between two parties that essentially mirror the terms of a contract that one of the parties has with a third party, if the third-party contract is modified to replace an IBOR-referencing rate or fallback provision, the taxpayer would want to modify the internal back-to-back contract to be consistent with the changes to the third-party contract. In that situation, the rationale for turning off the application of the fair market value rule to the unrelated party contract should also apply to the changes made to the internal contract. For related taxpayers where at least one is subject to a financial regulatory regime, the regulatory restrictions that are already imposed on these taxpayers often operate to require that any transactions between them are conducted on an arm's-length basis.<sup>33</sup>

### **3. Additional Recommendations Relating to the Fair Market Value Requirement**

The ARRC recommends that Treasury make additional changes to the fair market value requirement described below to provide greater certainty and minimize the administrative burden associated with modifying contracts to address the IBOR discontinuation.

#### **a. Add New Financial Accounting Safe Harbor**

As discussed above, the FASB has issued proposed relief providing that certain IBOR-related modifications do not result in a deemed extinguishment of a contract.<sup>34</sup> For taxpayers seeking to modify large numbers of contracts referencing IBORs, any book-tax differences would present significant compliance and reporting issues. For this reason, and because taxpayers would have already invested significant resources analyzing the treatment of modifications for financial accounting purposes, a financial accounting safe harbor would reduce the administrative burden for such taxpayers significantly. In addition, as noted above, the ARRC believes that the purpose and principles underlying the Proposed Regulations are

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<sup>33</sup> Cf. Section 1.385-3(g) (providing an exemption from the general and funding rules for regulated financial companies). Financial institutions are heavily regulated by multiple governmental agencies, both on a consolidated basis and a standalone basis with respect to banks and broker-dealers. For example, bank holding companies and savings and loan holding companies are regulated and supervised by the Board of Governors of the Federal Reserve System, national banks are regulated and supervised by the Office of the Comptroller of the Currency ("OCC"), state banks are regulated and supervised by state regulators and on the federal level primarily by either the Board of Governors of the Federal Reserve System or the Federal Deposit Insurance Corporation ("FDIC"), and, regardless of the primary federal regulator, insured depository institutions are also regulated by the FDIC. Overseas branches of national banks are regulated and supervised by the Board of Governors of the Federal Reserve System and OCC and overseas subsidiary banks are regulated and supervised by the Board of Governors of the Federal Reserve System.

In addition, financial institutions are subject to further regulatory restrictions that prevent gratuitous transfers to related parties. For example, Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. §§ 371c, 371c-1), implemented by Federal Reserve Regulation W (12 C.F.R. pt. 223), impose restrictions on transactions between banks and affiliates. In particular, Section 23B of the Federal Reserve Act requires that "covered transactions" between a bank and its affiliates be at arm's length and on market terms. The Federal Reserve's Regulation O (12 C.F.R. pt. 215) also imposes a market terms requirement for extensions of credit to insiders of a bank or its affiliates.

<sup>34</sup> See *supra* notes 27–28 and accompanying text (discussing the new accounting safe harbor adopted by the FASB under GAAP).

sufficiently similar to those underlying the FASB relief that aligning the two will produce appropriate results.

Accordingly, the ARRC recommends the adoption of a new financial accounting safe harbor providing that if under GAAP or IFRS, as applicable, an alteration or modification of a contract otherwise described in Proposed Section 1.1001-6(a)(1)–(3) or (5) does not result in a deemed extinguishment of the contract for financial accounting purposes, the fair market value requirement would be deemed to be satisfied. For example, if a modification is presumed to be related to the IBOR transition under the FASB relief and the taxpayer has made the relevant accounting election, such modification would not result in an extinguishment of the contract and thus would satisfy this proposed accounting safe harbor. Even if the modification were not considered “related to the replacement of the reference rate” under the FASB relief, if such modification does not otherwise result in an extinguishment of the contract under applicable GAAP (for example, in the case of a debt instrument, because the change in the present value of projected future cash flows is less than ten percent), such modification would also satisfy this proposed accounting safe harbor. This safe harbor would apply only to taxpayers that issue audited financial statements in accordance with such accounting standards.

b. Expand Historic Average Rate Safe Harbor

Under Proposed Section 1.1001-6(b)(2)(ii)(A) (the “historic average rate safe harbor”), the fair market value requirement is deemed satisfied if, on the date of the alteration or modification, 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, after accounting for any adjustment to the spread and the value of any one-time payments. The safe harbor provides taxpayers with wide latitude, which the ARRC welcomes, in determining the historic averages of the relevant rates.<sup>35</sup>

Certain fallback provisions designed to address the anticipated discontinuation of IBORs, including the ISDA fallback provisions, are expected to use spread adjustment methods that take into account historic averages.<sup>36</sup> As a result, the historic average rate safe harbor is particularly relevant to the modification of an instrument to incorporate such a fallback provision.

However, by requiring the historic average to be tested as of the modification date, the safe harbor does not clearly apply to many fallback replacements. This is because many fallback provisions calculate the applicable spread adjustment not as of the modification date, i.e., when the modified fallback provision is incorporated into the terms of the contract, but rather on a later date (the “spread calculation date”). The spread calculation date would generally occur upon a specified event, for example when the discontinuation of the relevant IBOR is announced or established or when a regulator determines that the IBOR is no longer representative (a “pre-cessation trigger”). Depending on the results of the new consultation on ISDA Fallbacks published on February 24, 2020, the spread calculation date under the ISDA

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<sup>35</sup> Prop. Reg. § 1.1001-6(b)(2)(ii)(A).

<sup>36</sup> See the discussion of the spread adjustment methods in the ARRC December 2019 Letter.

fallback methodology could be the date of an official announcement by a regulator that the relevant IBOR will be unreliable or discontinued.<sup>37</sup>

For this reason, the ARRC recommends modifying the historic average rate safe harbor so that it applies to amendments to typical fallback provisions. Treasury could do so by expanding the safe harbor so that, in a case where the parties are modifying fallback provisions as contemplated by Proposed Section 1.1001-6(a)(3), the safe harbor is met where the fallback provision uses a historic average of rates that is measured at the time when the fallback provision's spread calculation date occurs as opposed to when the modification happens.

c. Only Test Value of Modifications Made, Not Entire Instrument

Due to the difficulty of valuing certain instruments, Treasury should provide that the fair market value requirement can be met by valuing only the elements of the contract that were changed and not the contract as a whole. For example, the fair market value requirement could be satisfied through a comparison of the present value of the IBOR-based cash flows under the unaltered contract and the replacement rate-based cash flows under the contract after the modification. This would significantly reduce the burden of performing a valuation with respect to contracts that are not publicly traded, and which in some cases may have significant value elements that have nothing to do with the IBOR replacement.

d. Eliminate the Consistency Requirement

Proposed Section 1.1001-6(b)(2)(i) permits taxpayers to use any reasonable, "consistently applied" method of valuation for purposes of determining whether the fair market value requirement is met. How the consistency requirement operates is not clear. Construed narrowly, the rule could require consistency only in the method of valuing the contract before and after the modifications, as opposed to consistency across contracts. However, such a principle would seem so obvious as to make an explicit rule unnecessary.

The language could alternatively be read to suggest that a taxpayer must use consistent valuation methods for all of its contracts. For a taxpayer modifying different types of contracts, or even broadly similar contracts that nonetheless reflect diverse circumstances, the consistency requirement may present significant limitations. Moreover, by referring to "the parties'" use of a particular valuation method for a contract, the regulation language implies that both parties to the contract must use the same valuation methodology.<sup>38</sup> If both parties must use the same methodology and a specific taxpayer must be consistent across its contracts, the general valuation rule is likely to be functionally useless for taxpayers that have numerous types of contracts with different parties, as it is highly unlikely that those other parties will all use a single valuation method that matches the taxpayer's method.

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<sup>37</sup> See *supra* note 5 for the ISDA 2020 consultation on pre-cessation fallbacks in derivatives.

<sup>38</sup> Even though Section 1001 generally presumes consistency in certain contexts, such as between issuers and holders with respect to debt instruments, consistency is not required in all contexts (e.g., for notional principal contracts under Sections 1.1001-4 and 1.446-3). Therefore, the ARRC believes that consistency should not be required across parties with respect to valuation methods. For example, unrelated parties could be relying on different reasonable valuation methods for their positions.

Because the consistency requirement appears either unnecessary (if construed narrowly) or unduly limiting (if construed broadly), the ARRC recommends eliminating this requirement from Proposed Section 1.1001-6(b)(2)(i). If Treasury decides to retain this requirement, the ARRC recommends applying it narrowly.

### **C. Qualified Rate Definition**

Proposed Section 1.1001-6(a)(3) applies, inter alia, to a modification of the terms of a contract “to include a qualified rate as a fallback to a rate referencing an IBOR and any associated alteration.” Proposed Section 1.1001-6(b)(1) defines a qualified rate to mean any rate that satisfies the fair market value requirement of Proposed Section 1.1001-6(b)(2), the currency requirement of Proposed Section 1.1001-6(b)(3) and is enumerated in Proposed Section 1.1001-6(b)(1). In addition to recommendations regarding the fair market value requirement discussed above, the ARRC makes the following recommendations with respect to the general qualified rate definition.

#### **1. Fallback Provisions**

##### **a. “Waterfall” Features**

Many fallback provisions operate by providing not a single specified substitute rate, but rather a multistep hierarchy, or “waterfall,” to determine a base rate and/or spread adjustment. If the first rule in the hierarchy is inoperable, the second rule applies, and so on.

The ARRC fallback provisions, for example, operate in this way—they provide a series of rules to determine each of the replacement base rates and the spread adjustment to apply to those rates. The last step in each of the ARRC-recommended waterfalls provides a transaction party with broad discretion to identify a replacement rate with the same tenor as the IBOR being replaced, after giving due consideration to any industry-accepted replacement rates for similar instruments or any replacement rate (or mechanism for determining a replacement rate) recommended by the ARRC or a similar governmental body. As an example, the waterfall for the replacement rate used in the ARRC’s recommendations for fallback language for floating rate notes is attached as Appendix II.<sup>39</sup>

For choosing the spread calculation methodology, which it calls the Benchmark Replacement Adjustment, the ARRC language provides a three-step waterfall. Generally, the first step in the spread waterfall provides that the spread will be calculated using a methodology

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<sup>39</sup> The last step in the waterfall of other ARRC-recommended fallback provisions includes a similar step with discretion. For example, the last step in the recommended fallback provisions for bilateral business loans provides that lenders may select a replacement rate “giving due consideration to (i) any selection or recommendation of a replacement rate or the mechanism for determining such a rate by the Relevant Governmental Body at such time or (ii) any evolving or then-prevailing market convention for determining a rate of interest as a replacement for the then-current Benchmark for U.S. dollar-denominated syndicated or bilateral credit facilities at such time.” See ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ORIGINATIONS OF LIBOR BILATERAL BUSINESS LOANS 25 (May 30, 2019), [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Bilateral\\_Business\\_Loans\\_Fallback.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Bilateral_Business_Loans_Fallback.pdf).

selected or recommended by the Relevant Governmental Body (as defined in Appendix II, which definition includes the ARRC). Second, if the replacement rate is equivalent to the ISDA Fallback Rate (as defined in Appendix II), the Benchmark Replacement Adjustment is the spread ISDA recommends for fallbacks for derivatives.<sup>40</sup> If the first two steps are not applicable, the third and final step of the spread adjustment waterfall requires that the transaction party select a spread giving due consideration to any market-accepted conventions. Under the ARRC recommended language, the spread is determined at the time that the benchmark replacement (i.e., the base rate) is determined.

In light of the anticipated discontinuation of LIBOR and other benchmark rates and the resulting focus on fallback provisions, it is logical that the newer, more robust fallback provisions would, as a matter of prudence, provide for multiple choices to determine the replacement rate and spread and not just a single approach. The market's experience with IBORs provides ample justification for avoiding fallback provisions that rely on references that might not be available in the future. It is similarly prudent for such fallback provisions to have a "failsafe" final step that gives a determining party some discretion to select a base rate and spread adjustment methodology if the primary ones are unavailable.

However, because Proposed Section 1.1001-6(a)(3) refers to the addition or substitution of "a qualified rate" in a fallback provision, it is not entirely clear whether a modification that inserts a modern fallback provision with a waterfall approach, such as the ARRC fallback provisions or a similar provision, meets this requirement. Because the final step in the waterfall provision provides some discretion to a calculation agent or other party, the potential rates in the waterfall are not by their terms required to be qualified rates. Nonetheless, it is clearly expected that such a rate would be a qualified rate (putting aside the fair market value requirement, which is addressed above). Therefore, the ARRC believes that the ARRC fallback provisions, and fallback provisions that rely on a similar waterfall approach, should not present policy concerns from the Treasury's standpoint.

Accordingly, Treasury should clarify that the existence of a waterfall or hierarchy does not preclude a fallback provision from meeting the qualified rate requirement, even if one or more of the lower steps in the waterfall does not expressly require a qualified rate. Such a clarification would be less important if Treasury adopts the ARRC's recommendation above in Part II.A to provide a general Section 1001 provision relating to the ARRC and ISDA fallback provisions and Substantially Similar Fallback Provisions. However, because market participants may adopt different fallback provisions that have a similar hierarchical approach, clarifying this issue would still be valuable and facilitate the adoption of more robust fallback provisions market-wide.

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<sup>40</sup> Note that for Adjustable Rate Mortgages, the ARRC recommended fallback language does not include the second step referencing the ISDA Fallback Rate. See ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK CONTRACT LANGUAGE FOR NEW CLOSED-END, RESIDENTIAL ADJUSTABLE RATE MORTGAGES 5 (Nov. 15, 2019), [https://www.newyorkfed.org/medialibrary/Microsites/arc/files/2019/ARM\\_Fallback\\_Language.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arc/files/2019/ARM_Fallback_Language.pdf).

## b. Two-Step Transition Provisions

For securitizations, in addition to a waterfall described above, the ARRC-recommended fallback language includes an optional two-step transition intended to allow contracts that include such provisions eventually to transition to a forward-looking term SOFR rate (“Term SOFR”) if such rate is not initially available.<sup>41</sup> Certain market participants may prefer the forward-looking Term SOFR to SOFR calculated in arrears based on daily compounding (“Compounded SOFR”)<sup>42</sup> for various reasons, including that the rate would be known at the beginning of an accrual period and that the forward-looking nature of Term SOFR makes it more comparable to IBORs. As explained by the ARRC, “[m]any members of the working group felt that Term SOFR is a sufficiently superior Benchmark Replacement such that provisions should be included in the fallback language that permit the Benchmark Replacement to ultimately fallback to Term SOFR, even if it is not initially available at the time of a Benchmark Transition Event.”<sup>43</sup> Under this recommendation, in the event Compounded SOFR is selected as the replacement rate, there will be a periodic (quarterly or otherwise) redetermination of whether Term SOFR would be selected as the replacement rate if the determination were made on that date. If so, Term SOFR will replace Compounded SOFR within a reasonable time thereafter<sup>44</sup> and the spread will be redetermined using Term SOFR (together, the “Two-Step Transition”).

Supporting a fallback provision with a Two-Step Transition feature will serve to encourage market participants to amend their contracts to incorporate more robust fallback provisions now, even if their preference is for a fallback rate that is not yet available, i.e., Term SOFR. Although a Two-Step Transition feature makes a fallback provision more complex than it ordinarily would be, taxpayers incorporating a Two-Step Transition feature would not be able to use the feature to manipulate the rules to achieve a result contrary to tax policy, given the fact that the relative values of Term SOFR and Compounded SOFR would not be known to the taxpayer at the time the contract is modified to incorporate such a fallback provision.

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<sup>41</sup> Term SOFR is a forward-looking term rate derived from objective pricing information from derivatives that reference overnight rates. It thus relies on the development of SOFR derivatives markets, and trading volume and liquidity in the futures market for SOFR derivatives must develop further in order to create robust forward-looking term rates. Although SOFR derivatives markets have just begun to develop, both the CME and ICE now offer SOFR future contracts. With trading volume on SOFR derivatives growing, the ARRC Paced Transition Plan anticipates that the creation of Term SOFR will occur by the end of 2021. The Paced Transition Plan is available at <https://www.newyorkfed.org/arrc/sofr-transition#pacedtransition>.

<sup>42</sup> Compounded SOFR is compounded daily SOFR over the applicable tenor in arrears with a lookback and/or suspension period. The rate is inherently backward-looking and does not take into account future expectations of interest rate movements. As a result, it will generally lag behind the market.

<sup>43</sup> See ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ISSUANCES OF LIBOR SECURITIZATIONS 20 (May 31, 2019) [hereinafter “ARRC Securitization Fallback Recommendations”], [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization\\_Fallback\\_Language.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization_Fallback_Language.pdf).

<sup>44</sup> For example, because of operational and systems considerations, some issuers may not be able to adopt the second rate immediately after such rate becomes available, even though the replacement would be mandatory and automatic once practical.

For debt instruments, the switch from Compounded SOFR to Term SOFR through the application of the Two-Step Transition feature would not be a modification under Section 1.1001-3 because the alteration would occur by operation of the terms of the instrument. While the rules are less clear for non-debt contracts, the ARRC believes that such an automatic switch should not be a tax event under general Section 1001 principles because of its non-discretionary nature. However, it would be helpful for Treasury to confirm this conclusion.

Moreover, it is not entirely clear how the Two-Step Transition feature would be tested under Proposed Section 1.1001-6 when the modification to a legacy contract to incorporate such a fallback provision is made, since that rule refers to fallback provisions referencing “a qualified rate” rather than multiple qualified rates. Accordingly, the ARRC recommends clarifying that if fallback provisions initially transition into one qualified rate and later automatically switch to a different qualified rate once the second such rate is available or within a reasonable time thereafter, these two rates would be treated as a single qualified rate for purposes of Proposed Section 1.1001-6 and no taxable exchange would occur from the subsequent change of the reference rate from the first qualified rate to the second qualified rate. See the discussion in Part V below for a similar recommendation for Proposed Section 1.1275-2(m).

This clarification would also be very beneficial for purposes of providing certainty that the transition to the second rate is not a change in terms after the startup day under Section 1.860G-1(a)(4). Without such a clarification (and a similar change to Proposed Section 1.1275-2(m), as discussed in Part V below), whether a REMIC regular interest incorporating the Two-Step Transition feature continues to qualify as such will be unclear.

## **2. *Additional Technical Recommendation to Qualified Rate Definition***

Proposed Section 1.1001-6(b)(1) provides that, for purposes of Proposed Section 1.1001-6, a rate must be listed in Proposed Section 1.1001-6(b)(1) in order to be considered a qualified rate. Proposed Section 1.1001-6(b)(1) enumerates 12 items, including any replacement rate designated by “the central bank, reserve bank, monetary authority or similar institution (including any committee or working group thereof).”<sup>45</sup>

The ARRC appreciates the flexibility and certainty provided by the list of enumerated rates that can be qualified rates in Proposed Section 1.1001-6(b)(1) and the ability for the IRS to add additional rates to this list through published guidance. Proposed Section 1.1001-6(b)(1)(ix) may be intended to include any replacement rates endorsed and recommended by the ARRC, but the current language does not clearly accomplish this objective. The ARRC is a group of private-market participants convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York, and not a committee or working group of those institutions. Therefore, the ARRC recommends expanding the parenthetical in Proposed Section 1.1001-6(b)(1)(ix) to include “any group endorsed or convened by the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of New York” in order

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<sup>45</sup> Prop. Reg. § 1.1001-6(b)(1)(ix).

to ensure that any rate it recommends as a replacement for an IBOR-referencing rate would be a qualified rate enumerated in Proposed Section 1.1001-6(b)(1).

### III. One-Time Payments<sup>46</sup>

This section addresses two issues relating to one-time payments: the sourcing of one-time payments made with respect to derivative contracts and the timing of recognition of one-time payments.

#### A. Sourcing of One-Time Payments on Derivative Contracts

The ARRC appreciates the guidance included in the Proposed Regulations regarding the source and character of any one-time payments made in connection with altering or modifying a contract to transition from referencing an IBOR to an alternative reference rate. Proposed Section 1.1001-6(b) provides that the source and character of such a payment “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.” The Preamble provides an example of an interest rate swap and notes that the source of a one-time payment on that swap will likely be determined under Section 1.863-7(b), which sources income attributable to most notional principal contracts to the residence of the recipient (except income attributable to certain qualified business units and effectively connected income). In addition, the Preamble states that a payment on a lease of real property would be treated as a payment of rent and sourced to the location of the property.

This guidance is very helpful for many derivative contracts, most importantly swaps—which make up the largest category of derivatives referencing IBORs—and debt instruments. However, for certain other derivative contracts, there is no clear law regarding the source or character of payments made during the term of the instrument. For example, because options and futures contracts generally do not provide for payments during the term of the contract, the Proposed Regulations do not resolve the uncertainty regarding the source and character of any one-time payments on such contracts. According to a report published by the ARRC,<sup>47</sup> as of the

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<sup>46</sup> The NYSBA Report recommends that final regulations limit the qualification of one-time payments as associated alterations to situations where the fixed spread component of the qualified rate is no smaller than that of the IBOR-referencing rate. See NYSBA Report, *supra* note 31, Recommendation 6.

The ARRC acknowledges the general expectation that the average level of an IBOR will exceed that of the rate recommended by relevant regulators to succeed it, either because the replacement rate is secured or because it is an unsecured overnight rate that has a very small credit spread (for example, the Sterling Overnight Interbank Average Rate). See Oliver Wyman, *Changing the World's Most Important Number* (2018), fig. 4 at 8, <https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2018/February/LIBOR-transition-POV-FINAL.pdf>. However, given the volatility of floating rates, it would be undesirable to limit taxpayers' flexibility through a general rule prohibiting a reduction in the applicable spread above the base rate. Therefore, if Treasury chooses to promulgate a rule along the lines of that proposed in the NYSBA Report, the ARRC suggests the use of a rebuttable presumption so that a taxpayer can use a spread reduction where such a reduction would be reasonable under the circumstances.

<sup>47</sup> See SECOND REPORT: THE ALTERNATIVE REFERENCE RATE COMMITTEE, NEWYORKFED.ORG (Mar. 2018) [hereinafter “SECOND REPORT”], <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report>.

end of 2016 there was an estimated \$46 trillion gross notional amount of interest rate options and \$34 trillion gross notional amount of forward rate agreements in the combined over-the-counter and exchange traded markets.<sup>48</sup> In the Preamble, Treasury and the IRS requested comments regarding the determination of source and character of one-time payments on contracts that do not ordinarily require payments during their term.

In the ARRC June 2019 Supplemental Submission, the ARRC proposed an amendment to the notional principal contract sourcing rule of Section 1.863-7 to expand its application to all derivative contracts as defined in Section 1.1001-4(b)(3) solely with respect to one-time payments made in connection with the transition from an IBOR to an alternative reference rate.

The ARRC believes that such a rule results in the appropriate sourcing for these payments. First, income recognized upon the settlement of an option, forward or futures contract is generally treated as gain and therefore sourced according to the residence of the recipient.<sup>49</sup> The one-time payment reflects the expected reduction of the payment at maturity under the contract, and therefore it would be logical to source it in the same way as the income that will ultimately be recognized at maturity. Moreover, such a sourcing rule would promote consistency across derivative contracts, as options, forwards and futures would be treated like notional principal contracts in respect of one-time payments. Finally, because there is ordinarily no withholding tax on these contracts, market participants, including withholding agents, may not be prepared from a systems standpoint to handle withholding on one-time payments.

Accordingly, the ARRC reiterates its request to treat one-time payments with respect to all derivative contracts as sourced according to the residence of the recipient.

## **B. Timing of Income on One-Time Payments**

In the ARRC April 2019 Letter, the ARRC did not make any recommendation regarding guidance on the timing of recognition of one-time payments, but noted that market participants would likely take differing positions and that such positions should be respected if reasonable and internally consistent.

The NYSBA Report analyzes different ways of accounting for such payments on debt instruments and notional principal contracts (current inclusion, recognition over the remaining term of the instrument, and deferral) and notes trade-offs among the various choices. For

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<sup>48</sup> An interest rate option is a cash-settled option on the spot rate of a specified bond, including an IBOR-referencing bond. See Chris B. Murphy, *Interest Rate Options Definition*, INVESTOPEDIA.COM (last updated June 25, 2019), <https://www.investopedia.com/terms/i/interestratesoptions.asp>. The option pays the difference between the value of the underlying bond and the strike price, if any, at maturity or an earlier settlement (if permitted). A forward rate agreement is a hedge against interest rate changes and can be used to lock in a fixed interest rate for an event expected to occur in the near future. See Chris B. Murphy, *Forward Rate Agreement - FRA*, INVESTOPEDIA.COM (last updated June 25, 2019), <https://www.investopedia.com/terms/f/fra.asp>. At settlement, the “borrower” receives (or pays) the present value of the interest savings (or additional interest cost) based on the spread between a fixed interest rate and a reference floating rate as if the borrower had borrowed a notional amount for a set period of time beginning on the settlement date. There are no payments made on interest rate options or forward rate agreements during the term of the instruments.

<sup>49</sup> See Sections 865(a), 1234(a)(1), 1234A.

example, current recognition is likely to be simplest from an administrative perspective, while recognition over time comports with general original issue discount (“OID”) principles. The report ultimately recommends that one-time payments be recognized over the remaining term of the instrument.

The ARRC believes that there are a number of competing considerations that affect the policy choice regarding timing of recognition of one-time payments. In particular, while a “recognition over time” approach has significant conceptual appeal, there is significant complexity in requiring taxpayers to calculate and pay tax, and withholding agents to report and withhold tax, on the basis of an accrual schedule. In addition, a new category of non-cash income is likely to necessitate significant technological investment for what is essentially a transition period. Additionally, the relative strength of the tax policy arguments in favor of different accounting methods may depend on the type of instrument being evaluated. For example, the NYSBA Report focused principally on debt instruments and notional principal contracts, but in the case of a derivative contract that is taxed under an “open transaction” accounting method, such as an option or forward contract, accounting for the one-time payment as an adjustment to the gain or loss recognized would seem more consistent with the general treatment of the contract than would a “recognition over time” approach.<sup>50</sup>

As a result of these issues, the ARRC has concerns about a prescriptive, “one size fits all” approach, and recommends instead allowing market participants to take positions that are reasonable in light of the nature of, and tax accounting principles applicable to, the instrument being modified, provided that they take a consistent approach in similar circumstances. For example, it would be helpful if Treasury could confirm in the Preamble that taxpayers can take their own positions with respect to timing of any income on one-time payments so long as such positions are reasonable, internally consistent in similar circumstances, and not contrary to existing law.

#### **IV. Integration and Hedging Transaction Rules**

The Proposed Regulations provide that an alteration of the terms of an instrument that is part of an integrated transaction under Section 1.1275-6 “to replace a rate referencing an IBOR with a qualified rate” is not treated as a “leg-out,” provided that the modified Section 1.1275-6 hedge continues to meet the requirements for such a hedge.<sup>51</sup>

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<sup>50</sup> An additional benefit of this treatment for options and forward contracts would be that it would mitigate the withholding tax issues that would arise if these payments are treated as current “fixed or determinable annual or periodical” income.

<sup>51</sup> Prop. Reg. § 1.1001-6(c). For simplicity, this discussion focuses on integrated transactions under Section 1.1275-6, but any guidance provided by Treasury should apply in the same manner to Sections 1.988-5, 1.446-4 and 1.148-4(h).

We note that Proposed Section 1.1001-6(c), which provides that a modification to replace an IBOR-referencing rate with a qualified rate on one or more legs of a transaction will not be treated as a disposition or termination within the meaning of Section 1.446-4(e)(6), does not currently reference the hedging transaction rules under Section 1221. Under Section 1.1221-2(f), a taxpayer must identify a hedging transaction on the day on which the taxpayer enters into the transaction, and must make substantially contemporaneous identification of the hedged (...continued)

## **A. Recommendations Relating to Fallback Provisions**

The ARRC makes two recommendations relating to the application of Proposed Section 1.1001-6(c) to fallback provisions. First, it recommends clarifying that the regulation does apply to the modification or incorporation of fallback provisions, as the language does not clearly do so. Second, it recommends clarifying that differences in fallback provisions between a qualifying debt instrument (a “QDI”) and its associated hedge (the “1.1275-6 hedge”) do not give rise to a “leg-out” with respect to the synthetic debt instrument.

### **1. Clarify That Proposed Section 1.1001-6(c) Applies to Fallback Provisions**

Although we understand that Proposed Section 1.1001-6(c) was intended to be broad, it does not explicitly address the modification of fallback provisions, as opposed to the contractual interest rate itself. Therefore, the ARRC requests that final regulations clarify that a modification to contractual fallback provisions under Proposed Section 1.1001-6(a)(3) does not cause a “leg-out” of an integrated transaction under Section 1.1275-6 or 1.988-5, a disposition or termination of one or more legs of a transaction subject to the hedge accounting rules of Section 1.446-4 or a termination of a qualified hedge under Section 1.148-4(h).

### **2. Clarify That Differences Between Fallback Provisions Do Not Prevent Integration or Cause a “Leg-Out”**

One criterion for integration is that, for a taxpayer hedging a floating-rate debt instrument, the combined cash flows of the QDI and the 1.1275-6 hedge permit the calculation of a yield to maturity.<sup>52</sup> Under the integration regulations, a “leg-out” with respect to a synthetic debt instrument occurs if either component of the synthetic debt instrument is terminated or if the criteria for integration are no longer met.

Different segments of the financial markets may incorporate fallback provisions with different effective times, and those fallback provisions may reflect varying practices and standards for specific products. While the goal across segments of the financial markets is to prevent dislocations from arising upon the discontinuation of an IBOR, inconsistencies in IBOR fallbacks may nonetheless arise. For example, as described in footnote 9, many recent U.S. dollar syndicated loans provide for a mechanism whereby the borrower and administrative agent select a replacement interest rate based on the rate that is commonly used in newly originated loans at the time a permanent discontinuation of U.S. dollar LIBOR occurs (which could be Term SOFR, simple average SOFR, or Compounded SOFR, depending on market practice at

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(continued....)

item. Although a modification that is covered by Proposed Section 1.1001-6 is not treated as a deemed exchange, and therefore there should be no requirement to re-identify the modified hedge for purposes of continued treatment as a hedging transaction under Section 1.1221-2, because Section 1.446-4 and Section 1.1221-2 operate in parallel, it would avoid any negative inference and eliminate uncertainty if Treasury could add a reference to Section 1.1221-2 in Proposed Section 1.1001-6 to go along with the reference to Section 1.446-4.

<sup>52</sup> Treas. Reg. § 1.1275-6(b)(2).

that time). If the borrower hedges such a loan with a floating-to-fixed swap and adheres to the Protocol, the swap fallback provision will generally result in the swap referencing Compounded SOFR. This potential mismatch between the loan's and the swap's fallback provisions, while relatively modest, could raise a question about whether the loan and swap may be integrated under Section 1.1275-6 in the first instance or, if they are already integrated at the time a fallback provision is modified in a way that causes this type of mismatch, a leg-out has occurred.

In summary, therefore, for a taxpayer that hedges IBOR-based debt with an IBOR-linked contract, the adoption of a new fallback provision in one component of the synthetic debt instrument could potentially cause a leg-out if (i) the fallback provision of the hedge no longer matches the fallback provision of the QDI it hedges in timing and/or amount and (ii) the possibility that the fallback methodologies are triggered, e.g., the cessation of the relevant IBOR, is not "remote." Similarly, such differences could prevent integration of new debt instruments with corresponding hedges that do not have matching fallback provisions.

The ARRC thus requests that final regulations clarify that differences between fallback provisions in different components of an integrated transaction would not preclude integration or cause a "leg-out" of an integrated transaction under Sections 1.1275-6 or 1.988-5, a disposition or termination of one or more legs of a transaction subject to the hedge accounting rules of Section 1.446-4 or a termination of a qualified hedge under Section 1.148-4(h). By analogy to Proposed Section 1.1275-2(m), a contingency arising from fallback provisions could be viewed as a remote contingency that does not prevent integration.<sup>53</sup> This would permit taxpayers as much time as possible to cure any potential fallback mismatches before there is an actual economic mismatch in cash flows.

## **B. Differences in Reference Rates**

The ARRC anticipates that, notwithstanding efforts to minimize dislocations that arise from the IBOR cessation, there will be circumstances in which, either as a result of the types of fallback inconsistencies described above, or because of the transition of one leg in advance of the other leg, the two legs of an integrated transaction may have mismatches in their actual reference rates for some periods of time. This section describes those circumstances, as well as potential steps that taxpayers may take to mitigate the resulting mismatches, and discusses recommendations to address them.

Mismatches in actual reference rates could occur when, for example, a taxpayer that hedges an IBOR-based QDI with an IBOR-linked 1.1275-6 hedge and that wishes to change the IBOR reference rate in both instruments is not able to ensure that the reference rates are updated at the same time.<sup>54</sup> This may arise, for instance, because a taxpayer that is an obligor

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<sup>53</sup> Although the hedging transaction rules are less strict than the integration rules in requiring a matching of terms between the hedging transaction and the hedged item, it would be helpful as an administrative matter if any relief apply equally to the hedging transaction rules under Section 1.1221-2.

<sup>54</sup> For purposes of this discussion, we assume all modifications to the QDI and the 1.1275-6 hedge are IBOR-related modifications that do not result in a Section 1001 exchange under Proposed Section 1.1001-6.

on LIBOR debt that is hedged with a fixed-to-LIBOR swap may be able to cause the swap to be modified (either bilaterally or through adherence to the Protocol) to reflect SOFR in advance of a similar change with respect to the debt instrument. Similarly, a fallback provision in a debt instrument could be triggered, resulting in the reference rate in the debt instrument switching to SOFR at a time when the swap's floating leg is still indexed to LIBOR.<sup>55</sup> Alternatively, as described above, even if the fallback provisions in the debt instrument and the swap contract are triggered at the same time, they may reference different replacement rates (e.g., the debt instrument may reference simple average SOFR whereas the swap contract may reference Compounded SOFR). Absent specific relief, each of these events could result in a leg-out because it would no longer be possible to compute a yield to maturity on the synthetic debt instrument under the principles of Section 1272 due to the differences in the reference rates of the two legs.

The NYSBA Report recommends that, if the changes to the individual components of an integrated transaction are covered by Proposed Section 1.1001-6, there would be no leg-out of the integrated transaction even if the resulting QDI and 1.1275-6 hedge would no longer satisfy the requirements for integration if tested after the removal of the IBOR-referencing rate.<sup>56</sup> While the ARRC appreciates that such a rule would represent a significant expansion of the integration rules under current law, the ARRC would be supportive of such a rule were Treasury to promulgate it. Such a rule would help, among other things, to mitigate administrative burdens affecting a taxpayer's hedging program and that arise from circumstances over which it may not have full control.

While some taxpayers may choose to bear the type of rate mismatch described above, perhaps for temporary periods, others may seek to avoid the economic risk inherent in such a mismatch by entering into additional hedge positions.<sup>57</sup> For example, some market participants

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<sup>55</sup> For example, the debt instrument may be modified to include ARRC-recommended fallback provisions that include a pre-cessation trigger, i.e., the replacement provisions would be effective when IBOR is no longer representative, whereas the swap may be modified to include the ISDA Definitions, which may include only a permanent cessation trigger, i.e., the replacement provisions would be effective when the administrator ceases to provide IBOR permanently or indefinitely. As a result, the debt instrument and contract may not have matching cash flows between the pre-cessation date and the permanent-cessation date. Note that ISDA is reconsidering whether it should include a pre-cessation trigger. See *supra* note 5.

<sup>56</sup> See NYSBA Report, *supra* note 31, Recommendation 10.

<sup>57</sup> If an IBOR-based QDI contains a fallback provision that causes the rate to fix upon the permanent discontinuation of the IBOR and is integrated with a fixed-to-floating hedge to create a fixed rate synthetic debt instrument, it is possible that when the fallback provision is triggered, causing the QDI to become fixed, the taxpayer would terminate the associated floating-to-fixed 1.1275-6 hedge and simply hold the fixed-rate QDI until maturity. Such a termination would cause a leg-out event under Section 1.1275-6(d). Under Sections 1.1275-6(d)(2)(ii)(B) and (C), if a taxpayer legs out of an integrated transaction, the taxpayer is treated as selling or otherwise terminating the synthetic debt instrument for its fair market value immediately before the leg-out.

The changes in fair market value of the synthetic debt instrument are likely to be relatively small. However, for taxpayers with a number of such instruments, the administration of the book-tax differences resulting from leg-outs of this type could be disproportionately burdensome. Therefore, it would be desirable if Treasury could provide that Sections 1.1275-6(d)(2)(ii)(B) and (C) do not apply to taxpayers that have a leg-out event resulting from a termination (...continued)

may choose to bridge the gap by entering into a SOFR-to-LIBOR “basis swap,” or a Compounded SOFR-to-simple average SOFR “basis swap,” with a counterparty. Such a basis swap may have a term that matches the remaining term of the QDI or may instead have a short term that is intended to manage the expected period in which the legs of the synthetic debt instrument do not match. Depending on the term of the basis swap and the expectation regarding future events (e.g., when fallback provisions would be triggered), the basis swap, when combined with the QDI and the original 1.1275-6 hedge, could potentially approximate the cash flows of a synthetic fixed or floating rate debt instrument. Such a basis swap would potentially be terminated if it became no longer necessary, e.g., when the cash flows of the QDI and the original 1.1275-6 hedge match again because all of the components of the synthetic debt instrument have been switched to SOFR (calculated using the same methodology), or when different versions of SOFR in the QDI and the original 1.1275-6 hedge switch to the same Term SOFR pursuant to a Two-Step Transition provision.

The ARRC believes that guidance facilitating this form of transitional hedging under the integration rules would provide significant practical utility. For example, Treasury could provide that no leg-out has occurred if, contemporaneously with the mismatch event described above (e.g., within 30 days of such mismatch event), the taxpayer enters into one or more additional financial instruments that, when combined with the original components of the synthetic debt instrument, permit the calculation of a yield to maturity under Section 1272 principles based on reasonably expected cash flows. For this purpose, the yield-to-maturity requirement should be read liberally, so as to allow basis swaps that bridge a temporary mismatch as well as those that apply to the remainder of the term of the debt instrument.

If Treasury does not adopt this recommendation, it could at least provide that upon such a leg-out event, the taxpayer could “leg in” to a new integrated transaction without being required to wait 30 days as would normally be the case under the integration rules.<sup>58</sup>

Further, assuming that the basis swap is treated as integrated with the original QDI and 1.1275-6 hedge<sup>59</sup> (either because there has not been a leg-out event in the past 30 days with respect to the original synthetic debt instrument or because Treasury adopts the recommendation above), a subsequent termination of the basis swap would cause a leg-out under Section 1.1275-6(d)(2) because the taxpayer “terminates all or part of the qualifying debt

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(continued....)

of a 1.1275-6 hedge in a context in which the underlying QDI has become a fixed-rate debt instrument by reason of an IBOR fallback provision.

<sup>58</sup> See Treas. Reg. § 1.1275-6(c)(1)(v) (taxpayers cannot “leg in” within 30 days of the “leg-out” date); Treas. Reg. § 1.988-5(a)(6)(ii)(E) (taxpayers cannot “leg in” for any period after the “leg-out” date).

<sup>59</sup> A 1.1275-6 hedge could consist of a combination of financial instruments. See Treas. Reg. § 1.1275-6(b)(3) (“For purposes of this section, a financial instrument is a spot, forward, or futures contract, an option, a notional principal contract, a debt instrument, or a similar instrument, or combination or series of financial instruments.”).

instrument or § 1.1275-6 hedge.”<sup>60</sup> Treasury could support this type of transitional hedging activity by allowing a taxpayer to terminate such a basis swap without causing a “leg-out” under Section 1.1275-6 when the basis swap is no longer needed, i.e., when the legs of the original synthetic debt instrument match (whether by reason of the operation of the fallback provisions or by the taxpayer modifying the contractual reference rate).

The ARRC supports the facilitation of risk management activity relating to the IBOR transition. The ARRC therefore recommends guidance of the type described above that would enable taxpayers to use additional derivatives to preserve the economic effect of their integrated transactions in light of mismatches caused by the discontinuation of IBORs. Market participants are still studying ways of managing the cash flow risks inherent in the IBOR transition. Because the market’s response to these discontinuities is evolving as the IBOR discontinuation grows closer, flexibility in the ways in which taxpayers will be able to qualify under the integration rules would be beneficial.

## **V. Recommendation Relating to the OID Regulations: Two-Step Transition Provisions**

Proposed Section 1.1275-2(m) provides that, for variable rate debt instruments that provide both for a qualified floating rate that references an IBOR and for a methodology to change the IBOR-referencing rate to a different rate in anticipation of the IBOR becoming unavailable or unreliable, (i) the IBOR-referencing rate and the different rate are treated as a single qualified floating rate for purposes of Section 1.1275-5,<sup>61</sup> (ii) the possibility that the IBOR will become unavailable or unreliable is treated as a remote contingency for purposes of Section 1.1275-2(h)<sup>62</sup> and (iii) the fact that an IBOR becomes unavailable or unreliable is not treated as a change in circumstances for purposes of Section 1.1275-2(h)(6).<sup>63</sup>

As discussed above in Part II.C.1, many taxpayers may prefer Term SOFR, and the ARRC fallback provisions for securitizations accommodate this preference by incorporating a Two-Step Transition. The use of a fallback provision with a Two-Step Transition may present concerns under Proposed Section 1.1275-2(m) that are similar to those discussed above with respect to Proposed Section 1.1001-6. The ARRC therefore recommends clarifying that the final regulations implementing Proposed Section 1.1275-2(m) apply to fallback provisions that initially transition into one qualified rate and later automatically switch to a different qualified rate once the other rate is available or within a reasonable time thereafter.

Similarly, this clarification to Section 1.1275-2(m) would also provide helpful certainty with respect to REMIC regular interests that incorporate a Two-Step Transition. Treating the use of one rate followed by a second rate under a fallback provision with a Two-Step Transition

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<sup>60</sup> Treas. Reg. § 1.1275-6(d)(2).

<sup>61</sup> Prop. Reg. § 1.1275-2(m)(2).

<sup>62</sup> Prop. Reg. § 1.1275-2(m)(3).

<sup>63</sup> Prop. Reg. § 1.1275-2(m)(4).

as a single rate for purposes of Section 1.1275-5 will clarify that a REMIC regular interest incorporating a Two-Step Transition may remain qualified when the second rate becomes effective under the terms of the instrument.

## VI. Fixed Investment Trusts

Regulations promulgated under Section 7701 generally treat a trust formed to hold assets for the benefit of holders of trust certificates as an “investment trust” provided there is not a power under the trust document to vary the investment of the certificate holders.<sup>64</sup> An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under Section 301.7701-2; however, an investment trust with multiple classes of ownership interests, in which there is no power to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose. For example, a trust that holds a portfolio of bonds and issues certificates, each of which entitles the holder to a particular payment with respect to a specific bond, is classified as a trust.<sup>65</sup> Each certificate provides the holder with a direct interest in what is treated under Section 1286 as a separate bond. Similarly, the IRS has ruled that a trust that holds real estate mortgages or a REMIC regular interest and issues certificates that represent strips of interest payments that satisfy the REMIC specified portion rules is properly classified as an investment trust (a “Variable Strip Trust”).<sup>66</sup> The certificates in the ruling were fixed rate classes, floating rate classes or inverse floating rate classes. The floating rate and inverse floating rate classes issued by Variable Strip Trusts like those in the IRS rulings typically have pass-through rates that are based on an IBOR.

For existing Variable Strip Trusts with certificates that pay interest based on an IBOR, taxpayers may seek to modify the floating rate and inverse floating rate formulas to provide fallback provisions in the trust document with an appropriate replacement rate at the time of (or in anticipation of) IBOR cessation. Even if such modification is not treated as a “significant modification” under Proposed Section 1.1001-6, it is not clear whether the addition of such fallback provisions, or events that trigger the application of a fallback provision contained in the trust document, would constitute a power to vary the investment of the certificate holders within the meaning of Section 301.7701-4(c)(1). If so, that could cause the investment trust to be classified as a business entity and not an investment trust.

Adding fallback language to the trust document or replacing the interest rate formulas at the time of IBOR cessation is not the type of alteration that should be considered an impermissible power to vary the investment of certificate holders. The same policy considerations that support not treating such alteration with respect to a debt instrument as a significant modification of the debt instrument also support not treating the alteration as

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<sup>64</sup> Treas. Reg. § 301.7701-4(c).

<sup>65</sup> Treas. Reg. § 301.7701-4(c)(2) (Ex. 4).

<sup>66</sup> See, e.g., Priv. Ltr. Rul. 201229003 (Apr. 19, 2012); Priv. Ltr. Rul. 200624005 (Mar. 6, 2006).

impermissibly varying the respective rights of certificate holders in the trust assets. Therefore, the ARRC recommends that Treasury provide that neither the modifications described in Proposed Section 1.1001-6(a)(1)–(3) and associated alterations defined in Proposed Section 1.1001-6(a)(5) nor the operation of a fallback provision will cause a Variable Strip Trust to fail to be classified as an investment trust within the meaning of Section 301.7701-4(c).

## VII. Fast-Pay Stock Guidance

Under Section 1.7701(l)-3(b)(2)(i), stock is fast-pay stock if it is “structured so that dividends . . . paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder’s investment (as opposed to only a return on the holder’s investment).” Under Section 1.7701(l)-3(b)(2)(i), unless “clearly demonstrated otherwise,” stock is presumed to be fast-pay stock if (i) it is structured to have a dividend rate that is reasonably expected to decline or (ii) it is issued for an amount that exceeds, by more than a de minimis amount, the amount at which the holder can be compelled to dispose of the stock. Under Section 1.7701(l)-3(b)(2)(ii), if stock is not fast-pay stock when issued, the stock is tested again under the fast-pay presumption rules “when there is a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances.” Fast-pay arrangements are listed transactions and are subject to additional reporting requirements.<sup>67</sup>

For parties making IBOR-related modifications to preferred stock that are within the ambit of Proposed Sections 1.1001-6(a)(1)–(3) and (5) and therefore do not result in a taxable exchange under Section 1001, the preferred stock should not be treated as “issued” for purposes of the fast-pay rules as a result of the modification. Therefore, the presumption that applies to stock that is issued for a value greater than its redemption price should not be implicated even if the fair market value at the time of the modification happens to exceed its redemption price. Similarly, it would seem like a stretch of the regulatory language to view stock as “structured” to have a declining dividend rate because it is modified under Proposed Sections 1.1001-6(a)(1)–(3) and (5) to replace an IBOR or a fallback provision even if, by happenstance, the expected value of the replacement rate is slightly less than the expected value of the IBOR, for example because the fallback provision uses a historical average for making spread adjustments, or if at the time of the modification interest rates are generally expected to decline over time. A similar analysis should apply to a rate change that occurs by operation of a fallback provision, even if such a change could conceivably be viewed as a “change in the relevant facts and circumstances.”

Accordingly, the ARRC believes that the language in the fast-pay regulations, as well as their underlying policy, leads to the conclusion that these regulations should not apply to ordinary-course modifications to preferred stock that are within the meaning of Proposed Sections 1.1001-6(a)(1)–(3) and (5). Nonetheless, given the extremely negative consequences of listed transaction status, guidance specific to the fast-pay regulations would be beneficial to taxpayers. Therefore, the ARRC recommends that Treasury clarify that neither (i) a

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<sup>67</sup> See Notice 2009-59, 2009-31 IRB 170; Treas. Reg. § 1.6011-4.

modification described in Proposed Sections 1.1001-6(a)(1)–(3) or (5) nor (ii) a change in rate that occurs by operation of a fallback provision in anticipation of or resulting from the IBOR becoming unavailable or unreliable will be considered a “significant modification” or a “significant change in the relevant facts and circumstances” for purposes of Section 1.7701(l)-3(b)(2).

### **VIII. Potential Changes in Method of Accounting**

Under Section 475, securities, including loans, are generally subject to mark-to-market tax treatment if held by a taxpayer that is a “dealer in securities.” In many cases, securities dealers value loans and other debt instruments for which market prices are not readily available using a discounted cash flow model. Such a model may employ an IBOR or other appropriate discount rate to reflect market interest rates. A discounted cash flow model may also be used for the valuation of certain swaps and other derivatives. Some dealers may have made an election under Section 1.475(a)-4 to use the values of eligible positions reported on certain GAAP-based financial statements, based on the discounted values of future cash flows, as the fair market values of these positions for purposes of Section 475. In addition, dealers that are required to file a financial statement with the U.S. Securities and Exchange Commission under Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, and/or under Rule 17a-5 or Rule 17a-12 promulgated thereunder, may use mark-to-market values reported on a qualified financial statement for the tax valuation requirement of Section 475.<sup>68</sup> A dealer that has historically used an IBOR to value categories of securities using a discount cash flow model (either under GAAP or separately for Section 475 purposes) will need to apply a different discount rate at the time that the IBOR is no longer published or is no longer viewed as an appropriate discount rate (e.g., due to reliability concerns).

Section 446(a) sets forth the general rule that taxable income “shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.” Once a method of accounting has been adopted, a taxpayer must obtain consent from the IRS to change it, even in the case of a change from an improper method to a proper method.<sup>69</sup>

Applicable Treasury regulations provide that “[a] change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also, a change in the treatment of any material item used in the overall plan for identifying or valuing items in

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<sup>68</sup> See Industry Director Directive, LB&I-4-1110-033 (Apr. 14, 2011) [hereinafter “IDD”]. Recognizing that “[t]he financial accounting valuation requirements for marking to market values that are reported on qualified financial statements are substantially similar to the valuation requirements under I.R.C. §475” and “independently valuing securities and commodities subject to I.R.C. §475 imposes a significant administrative burden on both taxpayers and LB&I,” the IDD has directed that examiners should not challenge mark-to-market values reported on a qualified financial statement for the tax valuation requirement of Section 475.

<sup>69</sup> Furthermore, Section 481(a) generally requires that, in calculating a taxpayer’s income for any year in which a change of method of accounting has occurred, certain adjustments “necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted” should be taken into account, except that such adjustments are not to be made to any taxable year in which a change of accounting method was not made “unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.”

inventory is a change in method of accounting.”<sup>70</sup> The term “item” is used to indicate any recurring incidence of income or expense.<sup>71</sup> An item is “material” if it involves the proper time for the inclusion of the item in income or the taking of a deduction.<sup>72</sup> However, a change in treatment resulting from a change in underlying facts is not a change in method of accounting.<sup>73</sup>

If a taxpayer wants to make a change in method of accounting, it must file IRS Form 3115 to request such change. Revenue Procedure 2015-13 provides procedures for both automatic and non-automatic changes in method of accounting. Revenue Procedure 2018-31 provides a list of automatic changes. If a taxpayer does not qualify to file under the automatic change procedures for the requested change in method of accounting for the requested year of change, the taxpayer must file under the non-automatic change procedures. The requested non-automatic change needs to be approved by the IRS National Office in a letter ruling.

As stated in the ARRC April 2019 Letter, the ARRC believes it is not entirely clear as a matter of law whether a change in discount rates would constitute a “change in treatment of a material item” for the purposes of Section 446 and whether, if so, such change would occur as a result of a “change in underlying facts.” In particular, if a dealer seeks to use SOFR prior to the time at which LIBOR becomes unavailable, it will be less clear that a change in underlying facts has occurred. For dealers that have elected to use the safe harbor under Section 1.475(a)-4, or that qualify for the IDD, such dealers should be treated as using the same “overall plan or system of identifying or valuing items in inventory” after switching to a different discount rate for financial statement purposes—i.e., they are still following the valuations in their financial statements—and thus have not changed their accounting method with respect to such positions. Indeed, the IDD states that agents should not challenge the Section 475 valuations for a taxpayer who is under the IDD and has a subsequent change in its method of valuation for financial statement purposes, even if the taxpayer does not file for a change in method of accounting.<sup>74</sup> If the change of discount rate is a change of accounting method, under the current rules taxpayers would need to file for a non-automatic change, and the IRS would need to issue separate letter rulings to each taxpayer. Absent specific relief, this would create significant uncertainties and administrative burden, both for taxpayers and for the IRS.

Because of the significant practical implication of this question, the ARRC again urges Treasury to provide guidance with respect to the potential change in accounting method resulting from IBOR transition. The ARRC recommends that Treasury confirm that the change of a discount rate used for purposes of Section 475 valuations of securities from an IBOR to

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<sup>70</sup> Treas. Reg. § 1.446-1(e)(2)(ii)(a). For dealers in securities, securities often constitute “inventory.”

<sup>71</sup> Examples of “items,” as provided in applicable Treasury regulations and in cases and rulings, include real estate taxes, annual fees for certain licenses and corporate officers’ bonuses. If similar items differ in some way that affects the way they are accounted for, it is likely they are separate “items.”

<sup>72</sup> Treas. Reg. § 1.446-1(e)(2)(ii)(a).

<sup>73</sup> Treas. Reg. § 1.446-1(e)(2)(ii)(b).

<sup>74</sup> See Frequently Asked Questions for I.R.C. § 475, question 4, IRS.GOV (last updated Dec. 20, 2019), <https://www.irs.gov/businesses/frequently-asked-questions-for-irc-ss-475>.

another rate, either in anticipation of the discontinuation of such IBOR or at the time at which the IBOR no longer is available, does not constitute a change of accounting method. The ARRC would be happy to discuss these issues should Treasury wish to do so.

## Appendix I

### Background to the ARRC Recommended Fallback Language

As early as 2013, global groups focusing on benchmark reform had noted the need for more robust fallback provisions in financial instruments.<sup>75</sup> However, as the ARRC observed in March 2018, most contracts referencing LIBOR do not appear to have envisioned a permanent or indefinite cessation of LIBOR and have fallbacks that would not be economically appropriate if this event occurs.<sup>76</sup> To address this issue, the ARRC published general guiding principles for more robust fallback contract language in cash products in July 2018.<sup>77</sup> Following these overall principles, the ARRC launched consultations seeking market-wide feedback on specific fallback proposals for five cash products, including adjustable rate mortgages, bilateral business loans, floating rate notes, securitizations and syndicated loans.<sup>78</sup> The comment periods for these products have closed, and the ARRC has published final recommended fallback language for each product. ISDA is also developing fallbacks for derivatives for inclusion in its standard definitions after consultation with market participants in 2018<sup>79</sup>, 2019<sup>80</sup> and 2020,<sup>81</sup> which are expected to be based on the compounded setting in arrears rate and the historical median approach to the spread adjustment.<sup>82</sup>

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<sup>75</sup> Bd. OF THE INT’ ORG. OF SEC. COMM’NS, FINAL REPORT: PRINCIPLES FOR FINANCIAL BENCHMARKS (July 2013), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf> (Principle 13 provides that users should be encouraged by administrators to “take steps to make sure that contracts or other financial instruments that reference a benchmark have robust fallback provisions in the event of [cessation of] the referenced benchmark.”).

<sup>76</sup> SECOND REPORT, *supra* note 47.

<sup>77</sup> ARRC GUIDING PRINCIPLES FOR MORE ROBUST LIBOR FALLBACK CONTRACT LANGUAGE IN CASH PRODUCTS, NEWYORKFED.ORG., <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-principles-July2018>.

<sup>78</sup> Information about the consultations, comments received and final recommended language is available at <https://www.newyorkfed.org/arrc/fallbacks-contract-language>.

<sup>79</sup> The 2018 consultation is available at <http://assets.isda.org/media/f253b540-193/42c13663-pdf/>. The results are available at <http://assets.isda.org/media/04d213b6/db0b0fd7-pdf/>.

<sup>80</sup> The 2019 consultation is available at <https://www.isda.org/a/n6tME/Supplemental-Consultation-on-USD-LIBOR-CDOR-HIBOR-and-SOR.pdf>. The results are available at <http://assets.isda.org/media/7793c77f/393bf5db.pdf>. The supplemental 2019 consultation on spread and term adjustments is available at <https://www.isda.org/2019/12/18/december-2019-benchmark-fallbacks-supplemental-consultation/>. The results have not been released.

<sup>81</sup> The 2020 consultation on pre-cessation fallbacks in derivatives is available at <https://www.isda.org/a/iioTE/2020-Consultation-on-Pre-Cessation-Issues-Final.pdf>. The results have not been released.

<sup>82</sup> See INTERBANK OFFERED RATE (IBOR) FALLBACKS FOR 2006 ISDA DEFINITIONS: CONSULTATION ON FINAL PARAMETERS FOR THE SPREAD AND TERM ADJUSTMENTS IN DERIVATIVES FALLBACKS FOR KEY IBORS, ISDA.ORG., <https://www.isda.org/a/Ua0TE/Consultation-on-Parameters-for-Fallback-Adjustments.pdf>.

In recommending fallback language, the ARRC sought to minimize differences across assets classes while preserving appropriate differences unique to each product. Therefore, fallback language for each of the five cash products recommended by the ARRC, although not identical, bears resemblance to each other. They all include a multi-step waterfall that designates the order in which a replacement rate (usually rates based on SOFR or an alternate rate recommended by the relevant governmental body) should be used if the benchmark rate terminates or ceases to be representative.

## Appendix II

### ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Floating Rate Notes, Benchmark Replacement Waterfall<sup>83</sup>

Step 1: the sum of (a) a forward-looking term SOFR for the corresponding tenor that is selected or recommended by the Board of Governors of the Federal Reserve System and/or the Federal Reserve Bank of New York, or a committee officially endorsed or convened by such institution (including the ARRC) (the “**Relevant Governmental Body**”) (such rate, the “**Term SOFR**”) and (b) the Benchmark Replacement Adjustment (as described below);

Step 2: the sum of (a) a compounded average of daily SOFRs over the relevant period implemented in arrears (“**Compounded SOFR**”)<sup>84</sup> and (b) the Benchmark Replacement Adjustment; or alternatively, the sum of (a) a simple average SOFR and (b) the Benchmark Replacement Adjustment;

Step 3: the sum of (a) the alternate rate of interest that has been selected or recommended by the Relevant Governmental Body as the replacement for the then-current benchmark for the applicable corresponding tenor and (b) the Benchmark Replacement Adjustment;

Step 4: the sum of (a) the applicable fallback rate (without any spread adjustment) that is embedded in the ISDA standard definitions as written at the time of the then-current benchmark’s cessation, allowing for future modifications to such provisions (the “**ISDA Fallback Rate**”)<sup>85</sup> and (b) the Benchmark Replacement Adjustment; and

Step 5: the sum of (a) the alternate rate of interest that has been selected by the issuer or its designee as the replacement for the then-current benchmark for the applicable corresponding tenor that gives due consideration to any industry-accepted rate of interest as a replacement for the then-current benchmark for

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<sup>83</sup> ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ISSUANCES OF LIBOR FLOATING RATE NOTES, NEWYORKFED.ORG. (Apr. 25, 2019), [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN\\_Fallback\\_Language.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN_Fallback_Language.pdf).

<sup>84</sup> However, the ARRC recommendation acknowledged that at this time there is no standard set of “conventions” for use of this rate in the floating rate notes market. To facilitate a smooth transition, the definition of “Compounded SOFR” in the recommended fallback language leaves room for direction from the ARRC and/or market-accepted conventions once they emerge.

<sup>85</sup> The ISDA Fallback Rate currently embedded in the ISDA definition of “USD-SOFR-COMPOUND” is a waterfall that looks first to the replacement rate for SOFR recommended by the relevant governmental body (including the ARRC), then to the Overnight Bank Funding Rate published on the Federal Reserve Bank of New York’s website and then to the short-term interest rate target set by the Federal Open Market Committee and published on the Federal Reserve’s website.

U.S. dollar denominated floating rate notes at such time and (b) the Benchmark Replacement Adjustment.