Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part 1, §§ 148, 446, 988, 1001, 1275, 1.148-4, 1.446-4, 1.988-5, 1.1001-1, 1.1001-3, 1.1275-6)

Rev. Proc. 2020-44

SECTION 1. PURPOSE

The purpose of this revenue procedure is to facilitate the market's transition from the London Interbank Offered Rate (LIBOR) and other interbank offered rates (IBORs) to alternative reference rates through adoption of fallback language recommended by the Alternative Reference Rates Committee (ARRC) and the International Swaps and Derivatives Association (ISDA). In support of the ARRC's phased transition plan to assist market participants as they prepare for this transition away from IBORs, this revenue procedure provides that certain modifications to a contract with terms referencing an IBOR will not be treated as an exchange of property for other property differing materially in kind or extent for purposes of § 1.1001-1(a) of the Income Tax

Regulations. In addition, this revenue procedure provides that such modifications will not be treated as a legging out of an integrated transaction, a termination of a qualified hedge, or as a disposition or termination of either leg of a hedging transaction.

SECTION 2. BACKGROUND

.01 LIBOR and other IBORs. On July 27, 2017, the Financial Conduct Authority, the United Kingdom regulator tasked with overseeing LIBOR, announced that all currency and term variants of LIBOR, including U.S.-dollar LIBOR (USD LIBOR), may be phased out after the end of 2021. The Financial Stability Board and the Financial Stability Oversight Council have publicly acknowledged that, in light of the prevalence of USD LIBOR as the reference rate in a broad range of financial instruments, the probable elimination of USD LIBOR has created risks that pose a potential threat not only to the safety and soundness of individual financial institutions but also to financial stability generally.

.02 The ARRC and SOFR. The ARRC, whose ex officio members include the Board of Governors of the Federal Reserve System, the Department of the Treasury (Treasury Department), the Commodity Futures Trading Commission, and the Office of Financial Research, was convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York to identify an alternative reference rate that would be more robust than USD LIBOR and that would comply with standards such as the International Organization of Securities Commissions' "Principles for Financial Benchmarks." After considering a comprehensive list of alternatives, the ARRC recommended the Secured Overnight Financing Rate (SOFR) as the replacement for

USD LIBOR. Since April 3, 2018, the Federal Reserve Bank of New York has published SOFR daily.

.03 ARRC contract fallback language. The ARRC was also tasked with facilitating the voluntary acceptance of SOFR as the replacement for USD LIBOR. Many cash products, including newly issued cash products, refer to USD LIBOR and contain fallback provisions that do not adequately protect against the cessation of that benchmark. To support the transition from USD LIBOR, the ARRC has published recommended fallback language for inclusion in the terms of certain newly issued cash products, including floating rate notes, bilateral business loans, syndicated loans, securitizations, adjustable rate mortgages, and variable-rate private student loans. In each case, the fallback language describes the circumstances under which references to the current benchmark rate are replaced. When such a circumstance arises, the fallback language generally provides a mechanism for determining the replacement benchmark rate that supplants the current benchmark rate. The fallback language generally also provides a mechanism for determining a spread adjustment that is added to the replacement benchmark rate to account for any difference between the replacement benchmark rate and the current benchmark rate. Although the ARRC has recommended this fallback language for use in newly issued cash products, the ARRC believes that parties to outstanding cash products that refer to USD LIBOR will also modify the contracts relating to those cash products to incorporate the appropriate fallback language.

.04 ISDA and derivative contracts. The ARRC has also been actively engaged in work led by ISDA to ensure that the contractual fallback provisions in derivative contracts are sufficiently robust to prevent serious market disruptions if LIBOR is permanently discontinued. Documents published by ISDA, such as the 2002 ISDA Master Agreement and the 2006 ISDA Definitions, form the basic framework of many derivative contracts. Section 7.1 of the 2006 ISDA Definitions lists and defines the various standard floating rates from which the parties may choose in creating a derivative contract (rate options). These rate options may be combined with other elements, such as the addition of a fixed spread, to determine the overall floating rate under the derivative contract. Generally, the 2006 ISDA Definitions define each rate option by describing the methodology for determining the value of the rate option at each reset date. In the case of rate options that refer to IBORs, the 2006 ISDA Definitions also provide fallback provisions that generally designate another rate to stand in for the relevant IBOR if the IBOR is unavailable.

(1) The ISDA Supplement. By publishing supplements to the 2006 ISDA Definitions, ISDA can amend the provisions of the 2006 ISDA Definitions to address developments in the market. ISDA posted Supplement number 70 to the 2006 ISDA Definitions on *https://www.isda.org* on October 9, 2020, (ISDA Supplement) to facilitate inclusion of new fallbacks for certain key IBORs in derivatives transactions entered into on or after the date the ISDA Supplement takes effect. The ISDA Supplement has a final date of October 23, 2020, and a publication and effectiveness date of January 25, 2021. Among other things, the ISDA Supplement amends the fallback provisions for rate options that refer to IBORs to provide that, upon the occurrence of certain events, a

substitute rate identified in the ISDA Supplement replaces the relevant IBOR. For example, upon an official announcement or publication regarding the permanent discontinuation or unreliability of USD LIBOR, the ISDA Supplement generally provides that USD LIBOR is replaced by a rate that is the sum of tenor-adjusted SOFR and an adjustment spread based on the historical difference between USD LIBOR and tenor-adjusted SOFR. Derivative contracts entered into on or after the effective date of the ISDA Supplement will generally include the relevant terms of the 2006 ISDA Definitions as amended by the ISDA Supplement.

(2) The ISDA Protocol. Unless modified by the parties, the terms of derivative contracts entered into prior to the effective date of the ISDA Supplement (legacy derivative contracts) will not incorporate the terms of the ISDA Supplement. ISDA posted the final ISDA 2020 IBOR Fallbacks Protocol on *https://www.isda.org* on October 9, 2020, (ISDA Protocol) to facilitate adoption of the ISDA Supplement by parties to legacy derivative contracts. The ISDA Protocol will launch publicly and open for adherence on October 23, 2020. If parties adhere to the ISDA Protocol, all covered derivative contracts between those parties are generally modified to incorporate the terms of the ISDA Supplement or, in some cases, to incorporate a version of the terms of the ISDA Supplement adapted to fit the existing terms of the contract.

(3) Bilateral agreements. In some circumstances, legacy derivative contracts and other contracts may incorporate the terms of an ISDA Fallback (as defined in section 3.02 of this revenue procedure) on a transaction-by-transaction basis through an agreement between the parties to the contract (bilateral agreement) rather than through

adherence to the ISDA Protocol. For example, bilateral agreements may be necessary when some aspect of the law of a non-U.S. jurisdiction prevents adherence to the ISDA Protocol.

.05 Guidance on modifications to replace an IBOR. The Treasury Department and the Internal Revenue Service (IRS) have determined that it is appropriate to provide guidance on the tax consequences of modifying debt instruments, derivative contracts, and other contracts to replace IBORs or add fallback provisions to IBORs. The Treasury Department and the IRS published proposed regulations (84 F.R. 54068) on October 9, 2019 (Proposed Regulations).[1] On March 12, 2020, the ARRC submitted a letter to the Treasury Department and the IRS in which the ARRC provided comments on the Proposed Regulations.

In connection with development of the ISDA Protocol, the ARRC submitted written comments to the Treasury Department and the IRS on December 9, 2019, December 20, 2019, January 30, 2020, and July 10, 2020, recommending guidance on the tax consequences of modifying a contract as provided in the ISDA Protocol. (Those written comments and the ARRC's letter dated March 12, 2020, are collectively referred to as the "ARRC Letters.") The ARRC also recommended similar guidance for the ARRC Fallbacks (as defined in section 3.01 of this revenue procedure). For reasons detailed in the ARRC Letters, the ARRC has recommended issuing guidance that is separate from the Proposed Regulations and specific to the ARRC Fallbacks and the ISDA Protocol. Having reviewed the ARRC Fallbacks and the ISDA Protocol, the Treasury

[1] The preamble to the Proposed Regulations generally provides that a taxpayer may rely on the Proposed Regulations before the publication of the final regulations in the Federal Register.

Department and the IRS have concluded that interim guidance in advance of finalizing the Proposed Regulations is needed to support the adoption of the ARRC Fallbacks and the ISDA Protocol. The following paragraphs of this section 2.05 describe the guidance recommended by the ARRC.

(1) Guidance recommended under section 1001. Section 1001 of the Internal Revenue Code (Code) provides rules for determining the amount and recognition of gain or loss from the sale or other disposition of property. Section 1.1001-1(a) generally provides that gain or loss is realized upon the exchange of property for other property differing materially either in kind or in extent. In the case of a debt instrument, § 1.1001-3 provides rules for determining whether a modification of the terms of the debt instrument results in an exchange of the original debt instrument for a modified debt instrument that differs materially either in kind or in extent for purposes of § 1.1001-1(a). The ARRC Letters generally recommend guidance providing that the modification of a contract to incorporate the terms of an ARRC Fallback, an ISDA Fallback, or certain variants of an ARRC or ISDA Fallback described in section 4.02(3) of this revenue procedure does not result in an exchange under § 1.1001-1(a).

(2) Guidance recommended on integrated transactions. A debt instrument and one or more derivative contracts may be treated in certain circumstances as a single, integrated instrument for certain specified purposes. For example, § 1.1275-6 describes the circumstances under which a debt instrument may be integrated with a derivative contract for the purpose of determining the amount and timing of the taxpayer's income, deduction, gain, or loss. Sections 1.148-4(h) (regarding arbitrage

investment restrictions on tax-exempt bonds) and 1.988-5(a) (regarding foreign currency transactions) also provide rules by which a debt instrument may be integrated with a derivative contract. Similarly, § 1.446-4 generally provides that the method of accounting used by a taxpayer for a derivative contract that qualifies as a hedging transaction must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of the income, deduction, gain, or loss from the item or items being hedged. The modification or termination of a derivative contract or debt instrument that is part of an integrated transaction or hedging transaction under one of the foregoing regulations may result in unfavorable tax consequences, such as accelerating the recognition of gain. The ARRC Letters recommend guidance providing that the modification of an integrated transaction or hedging transaction to incorporate the terms of an ARRC Fallback, an ISDA Fallback, or certain variants of an ARRC or ISDA Fallback described in section 4.02(3) of this revenue procedure does not result in legging out of the integrated transaction, terminating either leg of the hedging transaction, or otherwise severing the integration authorized or required by the foregoing regulations.

SECTION 3. DEFINITIONS

This section 3 defines certain terms for the purpose of this revenue procedure.

.01 ARRC Fallback.

(1) In general. An "ARRC Fallback" is contract language that is recommended by the ARRC and identified in any one of sections 3.01(2)(i) through (ix) of this revenue

procedure.[2] An ARRC Fallback includes any option or variant provided in the contract language identified in sections 3.01(2)(i) through (ix) of this revenue procedure and excludes any option or variant not provided in the contract language identified in sections 3.01(2)(i) through (ix) of this revenue procedure, even if that option or variant is recommended elsewhere by the ARRC. As of October 9, 2020, the ARRC Fallbacks consist of recommended contract language for adjustable rate mortgages, bilateral business loans, floating rate notes, securitizations, syndicated loans, and variable-rate private student loans and are publicly available at *https://www.newyorkfed.org/arrc/fallbacks-contract-language*.

(2) <u>Identification of contract language</u>. The contract language contained in each of the following materials is identified in this section 3.01(2)—

(i) *Part II: Fallback Language for New Closed-End, Residential Adjustable Rate Mortgages* of the document entitled *ARRC Recommendations Regarding More Robust LIBOR Fallback Contract Language for New Closed-End, Residential Adjustable Mortgages*, dated November 15, 2019;

(ii) The section entitled *"Hardwired Approach" Fallback Language* of *Part II: Fallback Language for New Originations of LIBOR Bilateral Business Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans*, dated May 30,

[2] The ARRC Fallbacks do not include the amendment approach that the ARRC once recommended for bilateral business loans and syndicated loans. Rather than the more formulaic approach used by the ARRC in the ARRC Fallbacks, the fallback rate under the amendment approach is effectively determined by negotiation of the parties to the contract. As a result, the Treasury Department and the IRS have concluded that the addition and operation of the fallback provisions in the amendment approach should be evaluated under the standards provided in either the Proposed Regulations or, when published, the final regulations.

2019;

(iii) The section entitled *Hedged Loan Approach* of *Part II: Fallback Language for New Originations of LIBOR Bilateral Business Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans*, dated May 30, 2019;

(iv) *Part II: Fallback Language for New Originations of LIBOR Bilateral Business Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans*, dated August 27, 2020.

(v) *Part II: Fallback Language for New Issuances of LIBOR Floating Rate Notes* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Floating Rate Notes*, dated April 25, 2019;

(vi) *Part II: Fallback Language for New Issuances of LIBOR Securitizations* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations*, dated May 31, 2019;

(vii) The section entitled *"Hardwired Approach" Fallback Language* of *Part II: Fallback Language for New Originations of LIBOR Syndicated Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans*, dated April 25, 2019;

(viii) *Part II: Fallback Language for New Originations of LIBOR Syndicated Loans* of the document entitled *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans*, dated June 30, 2020; and

(ix) *Part II: Fallback Language for New Variable-Rate Private Student Loans* of the document entitled *ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Variable Rate Private Student Loans*, dated June 30, 2020.

.02 ISDA Fallback. An "ISDA Fallback" is the set of terms provided in any one of the sections numbered one through six in the version of the Attachment to the ISDA Protocol that is publicly available at *https://www.isda.org* as of October 9, 2020.

SECTION 4. SCOPE

.01 This revenue procedure applies to any contract with terms that reference an IBOR and that are modified as described in section 4.02 of this revenue procedure. For this purpose, a contract includes but is not limited to a derivative contract, a debt instrument, stock, an insurance contract, and a lease agreement.

.02 This revenue procedure applies to any of the following modifications—

(1) The contract is modified to incorporate an ISDA Fallback, regardless of whether that modification results from adherence to the ISDA Protocol or a bilateral agreement between the parties to the contract.

(2) The contract is modified to incorporate an ARRC Fallback.

(3) The contract is modified to incorporate the terms of either an ARRC Fallback or an ISDA Fallback with certain deviations, provided all deviations fall into one or more of the following categories—

(i) Deviations from the terms of an ARRC Fallback or an ISDA Fallback that are reasonably necessary to make the terms incorporated into the contract legally enforceable in a relevant jurisdiction or to satisfy legal requirements of that jurisdiction;

(ii) Deviations from the terms of an ISDA Fallback that are reasonably necessary to incorporate the ISDA Fallback into a contract that is not a Protocol Covered Document (as defined in the ISDA Protocol);

(iii) Deviations from the terms of an ARRC Fallback or an ISDA Fallback to omit terms of an ARRC Fallback or an ISDA Fallback that cannot under any circumstances affect the operation of the modified contract (for example, for a contract that refers only to USD LIBOR, omission of the portions of an ISDA Fallback that relate exclusively to contracts referring to another IBOR); or

(iv) Deviations from the terms of an ARRC Fallback or an ISDA Fallback to add, to revise, or to remove technical, administrative, or operational terms, provided that the addition, revision, or removal is reasonably necessary to adopt or to implement the ARRC Fallback or the ISDA Fallback. Examples of technical, administrative, or operational terms include the definition of interest period, the timing and frequency of determining rates, and the timing and frequency of making payments of interest. This section 4.02(3)(iv) does not apply to the addition of a term that obligates one party to make a one-time payment (or similar payments) as a substitute for any portion of an ARRC Fallback or an ISDA Fallback or as consideration for the modification.

SECTION 5. APPLICATION

.01 If a contract described in section 4.01 of this revenue procedure is modified as described in section 4.02 of this revenue procedure, that modification is not treated as the exchange of property for other property differing materially in kind or extent for purposes of § 1.1001-1(a). For example, in the case of a debt instrument that is described in section 4.01 of this revenue procedure and that is modified as described in section 4.02 of this revenue procedure, the modification is not treated as a significant modification for purposes of § 1.1001-3, which provides rules for determining whether the modification results in an exchange of the original debt instrument for a modified debt instrument that differs materially either in kind or in extent for purposes of § 1.1001-1(a).

.02 If a contract described in section 4.01 of this revenue procedure is one leg of a transaction integrated under § 1.1275-6 or § 1.988-5(a), the modification of that contract as described in section 4.02 of this revenue procedure is not treated as legging out of the integrated transaction under § 1.1275-6 or § 1.988-5(a). If a contract described in section 4.01 of this revenue procedure is integrated under § 1.148-4(h), the modification of that contract as described in section 4.02 of this revenue procedure is not treated as terminating the qualified hedge under § 1.148-4(h). If a contract described in section 4.01 of this revenue procedure is part of a hedging transaction under § 1.446-4, the modification of that contract as described in section 4.02 of this revenue procedure is not treated as a disposition or termination of either leg of the transaction under § 1.446-4.

.03 If a contract described in section 4.01 of this revenue procedure is modified as described in section 4.02 of this revenue procedure (covered modification) and is contemporaneously modified in a manner not described in section 4.02 of this revenue procedure (noncovered modification), the regulations identified in sections 5.01 and 5.02 of this revenue procedure apply to the noncovered modifications without regard to the special rules provided in sections 5.01 and 5.02 of this revenue procedure. In addition, when applying each regulation identified in sections 5.01 and 5.02 of this revenue procedure, the covered modifications are treated as part of the terms of the contract prior to any modification that is not a covered modification. As a result, covered modifications are treated as part of the existing terms of the contract against which other contemporaneous, subsequent, or cumulative modifications are tested under the regulations identified in sections 5.01 and 5.02 of this revenue procedure.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for modifications to contracts occurring on or after October 9, 2020, and before January 1, 2023. A taxpayer, however, may rely on this revenue procedure for modifications to contracts occurring before October 9, 2020.

SECTION 7. ADDITIONAL GUIDANCE

In future guidance published in the Internal Revenue Bulletin, the Treasury Department and the IRS may provide additional relief as necessary to address developments in the transition away from IBORs. For example, if the ARRC modifies the contract language identified in section 3.01(2) of this revenue procedure or recommends similar contract language for inclusion in other cash products after October 9, 2020, the Treasury Department and the IRS will evaluate the ARRC's new or revised contract language and may supplement the definition of an ARRC Fallback accordingly. The Treasury Department and the IRS request comments on the list of deviations in section 4.02(3) of this revenue procedure, including the need for additional categories of deviation in that list. Comments should be submitted in writing on or before December 31, 2022, and should contain a reference to this Rev. Proc. 2020-44.

All comments will be available for public inspection and copying. Commenters are strongly suggested to submit comments electronically, as access to mail may be limited. Comments may be submitted in one of two ways:

(1) Electronically via the Federal eRulemaking Portal at *https://www.regulations.gov* (type “IRS-2020-0029” in the search field on the homepage to find this revenue procedure and submit comments); or

(2) Alternatively, by mail to Internal Revenue Service, CC:PA:LPD:PR (Rev. Proc. 2020-44), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Spence Hanemann of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure contact Caitlin Holzem or Spence Hanemann at (202) 317-6842 (not a toll-free call).