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Legal Update

Limited US Tax Guidance for Adding ARRC and ISDA Fallbacks

Just in time for happy hour, on Friday, October 9, 2020, the Internal Revenue Service ("IRS") released Revenue Procedure 2020-44 (the "Revenue Procedure"), providing retroactive but limited relief for amending specific types of legacy contracts to add fallback mechanics for the London Interbank Offer Rate ("LIBOR") or other Interbank Offer Rates ("IBORs"). The fallback granted relief by the Revenue Procedure must rather strictly follow select model contract language recommended by the Alternative Reference Rates Committee (the "ARRC") or the International Swaps and Derivatives Association ("ISDA").[1]

As a key takeaway, the Revenue Procedure applies only to amending legacy instruments.

Background

If the title of this article caught your eye, you have undoubtedly heard that LIBOR may cease to be supported after the end of 2021. The ARRC 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 to be the successor to LIBOR.[2] Over the past year and a half, 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. For each, the fallback provisions describe the circumstances in which the replacement of an IBOR will occur along with a mechanism for determining the replacement rate (along with a spread adjustment).[3] ISDA has also released an ISDA supplement with model fallback terms along with a protocol for adhering parties to adopt the same.

The main US federal income tax concern for amending an outstanding financial instrument to add LIBOR fallbacks is whether the addition of the fallbacks results in a "significant modification."[4] If the replacement or addition of the new terms associated with the fallback is a "significant modification," holders of the instrument would have a deemed (potentially taxable) exchange of their "old" instrument for a "new" instrument. This deemed exchange could result in current gain recognition to a holder or counterparty.

Without specific guidance on the replacement of an IBOR rate, in order to avoid a deemed exchange, parties were left with relatively imperfect exceptions that invariably create uncertainty in many circumstances. At almost exactly this time in 2019, the IRS released proposed regulations (the "Proposed Regulations") that generally provide safe harbors in which the replacement of an IBOR with a fallback rate, or an addition of a fallback mechanic to an existing instrument, will not result in a deemed taxable exchange of the instrument under section 1001 of the Internal Revenue Code of 1986, as amended (the "Code").[5] The Proposed Regulations were not the perfect solution, so taxpayers and their advisors are hopeful that those regulations will be broadened in their final form.[6]

While the Revenue Procedure and the Proposed Regulations are both related to IBOR, the two pieces of guidance appear to be on separate tracks. The Revenue Procedure includes a premonition for the finalization of the Proposed Regulations but mentions little more about their content.

Guidance for Adding ARRC or ISDA Fallbacks

The guidance in the Revenue Procedure is straightforward: If an existing instrument is amended to include certain enumerated fallback mechanics published by the ARRC or ISDA (set forth in the following table), then that amendment is blessed and (a) the amendment is not treated as a deemed exchange under Code section 1001, and (b) in the case of certain integrated transactions and hedging transactions, the addition of the fallback mechanics does not disrupt the integration or hedge.[7] The table in the appendix sets forth the exact list of approved fallback mechanics (with links to the relevant ARRC and ISDA language included).

Enumerating a list of contractual provisions eligible for favorable tax treatment is certainly a novel approach for the IRS. The only permissible deviations from the prescribed ARRC or ISDA contract language are deviations (a) reasonably necessary to make the terms incorporated into the contract legally enforceable in a relevant jurisdiction or to satisfy legal requirements of that jurisdiction; (b) 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; (c) 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); and (d) 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 (the "Mechanical Deviation Exception").[8]

This approach works fairly well in the context of the ISDA amendments. In the ISDA context, there is a well-established framework for making amendments to existing contracts. If each party to an ISDA adheres to an ISDA Protocol (which will likely add them on a publicly available list, similar to the available list of parties adhering to the protocol addressing regulations under Code section 871(m)),[9] then all covered contracts between those two parties are automatically amended to include the ISDA fallback mechanics. In this case, there are generally no negotiations between the parties to the contracts, and the recommended ISDA fallbacks are included in full (with all transactions between the parties updated simultaneously).

In contrast, amendments to the terms of many debt instruments are unlikely to be amended automatically but must generally be amended by the parties. In addition, ISDA contracts can also be amended on a transaction-by-transaction basis through bilateral agreement. In these cases, it is more likely there could be deviation in the fallback language adopted. Over the past year, while many debt instruments have incorporated fallback provisions no doubt inspired by the ARRC language, it is rarer that the ARRC provisions are adopted without revision. As currently drafted, the Revenue Procedure requires those changes to fall within one of the four permissible deviations discussed above. The catchall candidate is the Mechanical Deviation Exception, which permits deviations to revise or to remove technical, administrative or operational terms as is reasonably necessary. The Revenue Procedure lists examples of technical, administrative or operational terms, including the definition of interest period, the timing and frequency of determining rates, and the timing and frequency of making payments of interest. The Mechanical Deviation Exception 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. To comfortably rely on the Revenue Procedure, taxpayers would be well-advised to analyze each deviation from the ARRC or ISDA fallback provisions to ensure those deviations are permissible. Some deviations may fall in a grey area in this regard.

Looking Ahead

The Revenue Procedure applies to contracts entered into on or after October 9, 2020, and before January 1, 2023. It is also retroactive, as taxpayers are permitted to rely on it for modifications to contracts occurring before October 9, 2020.

Until the Proposed Regulations are finalized (hopefully with a bit more flexibility), the Revenue Procedure arguably creates some incentive to use ARRC or ISDA fallbacks. The Revenue Procedure does not seem to provide a basis for granting a more favorable treatment to the ARRC/ISDA replacement language than to other types of fallbacks. Rather, the procedure provides that it is being published "[i]n support of the ARRC's phased transition plan." The Revenue Procedure will be a helpful tool for amending the terms of certain instruments as the financial community continues its progression away from referencing IBOR rates. However, the Revenue Procedure does not provide guidance on the full life cycle of IBOR replacement even where an amendment qualifies under the guidance because it does not address the consequences of ultimately replacing an IBOR down the road when the fallback is triggered. In that situation, taxpayers would need to apply the Proposed Regulations or the general exceptions under Code section 1001 to conclude there has not been a deemed exchange.[10]

If the ARRC modifies its model contract language, or publishes new model contract language, the IRS indicated it may supplement the Revenue Procedure. The IRS is open to comment on the Revenue Procedure, with the comment window open through December 2022.

Endnotes

[1] The Revenue Procedure is available at https://www.irs.gov/pub/irs-drop/rp-20-44.pdf.

[2] Notably, the Treasury Department is an ex officio member of the ARRC.

[3] For a more detailed discussion of the mechanics of some of the ARRC recommendations, see Brennan W. Young and Thomas A Humphreys, "Breaking Up With LIBOR," Tax Notes Federal (September 9, 2019) and Thomas A. Humphreys and Brennan W. Young, "The Tax Advisor's Practical Guide to LIBOR Replacement," The Journal of Taxation of Financial Products, Volume 16 Issue 4 (2019).

[4] Although the "significant modification" rules in Treas. Reg. section 1.1001-3 are specific to debt instruments, there are no clearly defined tax rules for when a deemed exchange occurs on non-debt instruments, and, accordingly, the rules for debt are often looked to for guidance.

[5] For a more detailed discussion of the Proposed Regulations, see our Legal Update, available at https://www.mayerbrown.com/en/perspectives-events/publications/2019/10/the-worlds-most-important-number-the-irs-addresses-the-replacement-of-libor. The Proposed Regulations are available at https://www.govinfo.gov/content/pkg/FR-2019-10-09/pdf/2019-22042.pdf.

[6] For a discussion of some of the imperfections of the Proposed Regulations, see, e.g., the Structured Finance Association comment letter on the regulations, available at https://structuredfinance.org/wp-content/uploads/2019/11/SFA-Comment-Letter-on-LIBOR-Transition-Treasury.pdf, and the ARRC comment letter on the regulations, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-comment-letter-treasury-IRS.pdf (among others).

[7] Specifically, the Revenue Procedure provides that the amendment (a) in the case of an integrated transaction under Treas. Reg. section 1.1275-6 or 1.988-5(a), is not treated as legging out of the integrated transaction; (b) in the case of an integrated transaction under Treas. Reg. section 1.148-4(h), is not treated as terminating the qualified hedge; and (c) in the case of a contract that is part of a hedging transaction under Treas. Reg. section 1.446-4, is not treated as a disposition or termination of either leg of the transaction.

[8] Revenue Procedure 2020-44, Section 4.02(3).

[9] *See* https://www.isda.org/protocol/isda-2015-section-871m-protocol/adhering-parties.

[10] Depending on the fallback rate reached by ARRC or ISDA contract language, under the rules existing before the Proposed Regulations, there may be an argument that the fallback mechanic is pursuant to the terms of the instrument or a unilateral option of the parties of the instrument. Under Treas. Reg. section 1.1001-3(c), an alteration of a legal right or obligation that occurs pursuant to the terms of a debt instrument is not a modification (and therefore not a “significant modification”), and issuer and holder options that can be unilaterally exercised are not modifications (provided, in the case of a holder option that the exercise does not result in a deferral of, or reduction in, any scheduled payment of principal or interest).

Appendix: List of Model Fallbacks Approved by the Revenue Procedure

Title and Specified Section	Date Published
ARRC Recommendations Regarding More Robust LIBOR Fallback Contract Language for New Closed-End, Residential Adjustable Mortgages, Part II	November 15, 2019
ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans, Part II, "Hardwired Approach" Fallback Language and Hedged Loan Approach	May 30, 2019
ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans, Part II	August 27, 2020
ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Floating Rate Notes, Part II	April 25, 2019
ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations, Part II	April 25, 2019
ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans, Part II, "Hardwired Approach" Fallback Language	April 25, 2019
ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans, Part II	June 30, 2020
ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Variable Rate Private Student Loans, Part II	June 30, 2020
ISDA IBOR Fallbacks Supplement and IBOR Fallbacks Protocol	Launching October 23, 2020

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Steven D. Garden
+1 312 701 7830
sgarden@mayerbrown.com

Thomas Humphreys
+1 212 506 2450
thumphreys@mayerbrown.com

Russell E. Nance
+1 212 506 2534
rnance@mayerbrown.com

Remmelt Reigersman
+1 415 874 4259
rreigersman@mayerbrown.com

Brennan W. Young
+1 212 506 2691
byoung@mayerbrown.com