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Global Tax Alert

US IRS confirms that some modifications to debt instruments and other contracts to reflect LIBOR discontinuation will not result in a deemed taxable exchange

In Revenue Procedure 2020-44, the United States (US) Internal Revenue Service (IRS) confirmed that certain fallback language modifying debt instruments, derivatives, and other financial contracts to cover the possible discontinuance of the London Interbank Offered Rate (LIBOR) will not cause a deemed taxable exchange for US federal income tax purposes. The confirmation also applies to other "interbank offered rates" (IBORs), such as the Euro Interbank Offered Rate (EURIBOR). In addition, the IRS confirmed that the modifications will not change the tax treatment of a "synthetic" debt instrument (i.e., an integrated debt instrument and hedge under Treas. Reg. Sections 1.988-5 or 1.1275-6).

The confirmation is relevant for (1) any issuer or holder of a floating debt instrument bearing interest based on LIBOR and (2) any party to a derivative contract, insurance contract, lease, or other contract that provides for payments based on LIBOR.

The Revenue Procedure applies to contract modifications made on or after 9 October 2020, and before 1 January 2023, but can be relied on for contracts modified before 9 October 2020.

Background

LIBOR and other IBORs are interest rate indices used as reference rates for floating-rate debt instruments, derivatives, insurance contracts, leases, etc. For example, a floating-rate US dollar debt instrument might bear interest at LIBOR plus a stated "spread." Historically, these rates were determined based on quotations by major banks of the amounts that they were paying, or would expect to pay, to borrow from other banks.

It has been widely reported in the press over the past several years that the process for determining such rates was no longer reliable. The United Kingdom (UK) Financial Conduct Authority, the regulator that oversees LIBOR, has announced that LIBOR may be phased out after 2021. Alternative indices that might be used as replacements include the Secured Overnight Funding Rate (SOFR) for US dollar transactions and the Sterling Overnight Index Average (SONIA) for UK pound-sterling transactions.

Because so many contracts are based on LIBOR, the US Federal Reserve convened an Alternative Reference Rates Committee (ARRC) to advise on the transition from LIBOR. The ARRC has published suggested "fallback language" for use in contracts to address what to do if LIBOR were discontinued and replaced with other indices. The International Swaps and Derivatives Association (ISDA), which publishes "master agreements" widely used in derivative transactions, has also suggested fallback language.

Tax rules implicated by the transition from LIBOR and other IBORs

Changing the terms of existing debt instruments and other contracts to non-IBOR reference rates raises tax issues under various sections of the Internal Revenue Code[1] and corresponding regulations.

Section 1001 and its regulations generally require taxpayers to realize gain or loss upon exchanging property for other property differing materially either in kind or in extent. Under Treas. Reg. Section 1.1001-3 (the Debt Modification Regulations), a debt instrument differs materially in kind or in extent if it undergoes a "significant modification." A modification is significant if, based on all of the facts and circumstances, the degree to which the legal rights and obligations of the parties are altered is economically significant. The Debt Modification Regulations also contain a specific rule for a change in the yield of a debt instrument. A significant modification results in the deemed exchange of the original instrument for a modified instrument, and thus realization of gain or loss on the original instrument.

Treas. Reg. Sections 1.988-5 and 1.1275-6 provide special rules under which debt instruments and the financial instruments used to hedge them can be integrated (i.e., treated as a single "synthetic" instrument) for certain tax purposes. Taxpayers that dispose of one leg (a leg out) of an integrated transaction (including via a significant modification of a debt instrument or a deemed exchange of the financial instrument under Section 1001) are generally treated as having terminated the integrated transaction and may realize gain or loss on *all* components of the transaction.

Historically, there was no guidance about how these rules (and others not discussed here) would apply to the transition from an IBOR to an alternative reference rate and whether the change would constitute a deemed taxable exchange. In October 2019, the IRS issued proposed regulations (REG-118784-18) addressing certain tax issues related to the transition to alternative reference rates (see EY Global Tax Alert, *US IRS issues proposed rules addressing the tax consequences of the elimination of LIBOR and other interbank offered rates*, dated 11 October 2019). Although these proposed regulations have not been issued in final form, taxpayers may currently rely upon them. In comment letters, the ARRC asked the IRS and Treasury to issue detailed guidance on the adoption of fallback provisions before the proposed regulations were finalized, to speed the incorporation of such provisions into transaction documents.

Revenue Procedure 2020-44

The IRS issued the Revenue Procedure as interim guidance on which taxpayers could rely until the proposed regulations are finalized. The Revenue Procedure specifies which ARRC or ISDA fallback language may be added to the terms of an instrument without creating a taxable exchange under Section 1001 or "leg out" of an integrated transaction. By specifying which language to add, the Revenue Procedure implies there will be no tax consequences if taxpayers subsequently modify the instrument's terms to reflect IBOR's discontinuation.

The Revenue Procedure applies to any contract that references an IBOR (including, but not limited to, debt instruments, derivative contracts, stocks, insurance contracts, and lease agreements). It is modified to (1) incorporate ARRC or ISDA fallback terms or (2) incorporate ARRC an ISDA fallback terms with certain deviations, such as those reasonably necessary to make the incorporated terms legally enforceable or implementable.

Implications

Given the very large number of financial instruments referencing LIBOR and other IBORs, the demise of these indices will affect numerous taxpayers. Revenue Procedure 2020-44 provides welcome guidance on one of the most pressing issues — whether the addition of contract language to handle a future transition to a new interest rate benchmark will result in a taxable exchange of an instrument referencing LIBOR or other IBORs for a new instrument. The Revenue Procedure, in an improvement over the proposed regulations, also provides some specific guidance on how the transition would apply when an instrument and a hedge are integrated under Treas. Reg. Sections 1.988-5 and 1.1275-6.

The Revenue Procedure is, however, limited to only certain, specific modifications. Specifically, it permits the incorporation of certain model fallback provisions, but by its terms does not apply to the addition of fallback language that does not follow the ARRC or ISDA model language, or to an immediate changeover to an alternative reference rate. Moreover, it does not address other issues addressed in the proposed regulations, such as the effect of the transition from LIBOR under the REMIC rules of Section 860G and the Section 882 rules for determining the deductible interest expense of a foreign corporation engaged in business in the US. In addition, neither the proposed regulations nor the Revenue Procedure addresses other issues related to the transition from LIBOR:

- **Tax accounting for one-time payments**. When an instrument is transitioned away from LIBOR, there may need to be a one-time payment from one party to the other if the modification changes the value of the instrument. The Revenue Procedure does not provide guidance on the timing of when that payment would be recognized, and the proposed regulations provide only limited guidance on the character of that payment.
- **Change to FMV of modified instrument**. Many practitioners have questioned the tax consequences if the value of the modified instrument, taking into account any adjustment to the "spread" and any one-time payment, is not the same as the unmodified instrument.
- **Margined derivative transactions**. Historically, many derivative transactions were cleared through central clearinghouses, where parties to transactions were required to post margin. Exchanges would use the effective cost of federal funds to compute the fair market value of the transactions, and thus, how much collateral would be required. On 16 October, two major clearinghouses operated by the CME Group and the LCH Group will begin using SOFR to determine these obligations, and will make a one-time cash payment to, or collect a one-time cash payment from, market participants to compensate them for a change in fair market value. ARRC has requested guidance on this change, as well on ancillary changes.

Taxpayers (and their foreign entities) need to evaluate all floating-rate debt instruments they hold or have issued, as well as derivative and other transactions into which they have entered, to determine if the Revenue Procedure may be relied upon to avoid the realization of gain or loss from contract modifications to include fallback language to account for the possible discontinuation of LIBOR.

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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