

INTERIM GUIDANCE PROVIDED BY REVENUE PROCEDURE FACILITATES LIBOR TRANSITION

The Internal Revenue Service recently issued [Revenue Procedure 2020-44](#), which is intended to facilitate the market's transition from the London Interbank Offered Rate (LIBOR) and other interbank offered rates (IBORs) to alternative reference rates through the adoption of fallback language developed by the Alternative Reference Rates Committee ("**ARRC**") or the International Swaps and Derivatives Association ("**ISDA**"). This revenue procedure is effective for modifications to contracts occurring on or after October 9, 2020 and before January 1, 2023. U.S. taxpayers, however, may rely on Revenue Procedure 2020-44 for modifications to contracts occurring before October 9, 2020.

Background

In 2017, the U.K. Financial Conduct Authority (the "**FCA**"), the regulator that oversees LIBOR, announced its intent to transition away from all currency and term variants of LIBOR by the end of 2021. Since the FCA made its announcement, regulators in various countries have put substantial effort into studying rates to determine the most appropriate way to replace IBORs that have been used in a myriad of contracts globally. This transition, however, will bring with it certain serious U.S. tax implications for contracts. In particular, modifying a contract to replace an IBOR based reference rate or to incorporate fallback provisions that lay out the process for replacing an IBOR based reference rate can result in a modified contract being treated as a new contract for U.S. tax purposes. In such case, parties to the contract (or their investors) otherwise subject to U.S. taxation would be required to recognize gain or loss on a deemed exchange of the modified contract for the new contract. Further, if the modified contract is part of a hedging or integrated transaction, the modification could result in the "legging out" or termination of the hedging or integrated transaction.

In 2019, in response to escalating concern regarding the tax consequences of the impending transition from IBOR, the U.S. Department of Treasury released

proposed regulations to address the most critical issues brought to its attention by agencies and associations, including the ARRC (the "**2019 Proposed Regulations**", our briefing regarding these is available [here](#)). The proposed regulations, however, did not account for all of the issues likely to arise in the transition away from IBOR. Since releasing the proposed regulations, the U.S. Department of Treasury and the U.S. Internal Revenue Service have determined that it is appropriate to provide further guidance, which they have released in the form of Revenue Procedure 2020-44.

Safe harbor

Revenue Procedure 2020-44 provides a safe harbor that allows legacy contracts to be modified to incorporate IBOR fallback provisions without triggering a deemed taxable exchange. To qualify for this safe harbor the modifications must adopt one of the ARRC or ISDA fallback provisions identified in the revenue procedure. Revenue Procedure 2020-44 identifies the following versions of ARRC recommended fallback provisions as qualifying for this safe harbor:

- fallback language for new issuances of LIBOR floating rate notes (April 25, 2019);
- fallback language for new issuances of LIBOR securitizations (May 31, 2019);
- "hardwired approach" or "hedged loan approach" fallback language for new originations of LIBOR bilateral business loans (May 30, 2019);
- "hardwired approach" or "hedged loan approach" fallback language for new originations of LIBOR bilateral business loans (Aug. 27, 2020);
- "hardwired approach" fallback language for new originations of LIBOR syndicated loans (April 25, 2019);
- fallback language for new originations of LIBOR syndicated loans (June 30, 2020);
- fallback language for new closed-end, residential adjustable rate mortgages (Nov. 15, 2019); and
- fallback language for new variable rate private student loans (June 30, 2020).

All of these recommended fallback provisions are available at <https://www.newyorkfed.org/arrc/fallbacks-contract-language>. Notably, no version of "amendment approach" fallback language will qualify for this safe harbor.

Revenue Procedure 2020-44 also identifies as qualifying fallback language the terms provided in sections 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.

The safe harbor provided under Revenue Procedure 2020-44 prevents a deemed exchange from occurring when a contract is modified to incorporate one of the identified LIBOR fallback provisions in accordance with the requirements of this revenue procedure. In addition, when the fallback provision is subsequently triggered, and the LIBOR based rate is replaced by operation of, and in

accordance with, the terms of the fallback provision, no deemed taxable exchange should occur at that time either.

Permitted deviations

The revenue procedure generally requires strict adherence to the qualifying ARRC or ISDA fallback language. Deviations are only permitted if they :

- 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;
- with respect to a deviation from the ISDA fallback language, are reasonably necessary to incorporate the ISDA fallback language into a contract that is not a Protocol Covered Document (as defined in the ISDA Protocol);
- omit terms provided by the fallback provision that would not 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 provision that relate exclusively to contracts referring to another IBOR); or
- add, revise, or remove technical, administrative, or operational terms, provided that the addition, revision, or removal is reasonably necessary to adopt or to implement the ARRC or ISDA fallback language.

If a contract includes additional benchmark replacement events, such as a transition to Term SOFR from Simple Daily SOFR if Term SOFR later becomes available, it would not qualify for this safe harbor.

Revenue Procedure 2020-44 further clarifies when a term is added to an ARRC or ISDA fallback provision that obligates one party to make a one-time payment (or similar payments), as a substitution for another term of the ARRC or ISDA fallback provision or as consideration for the modification, this would not constitute a permitted deviation.

If a modification to incorporate LIBOR fallback language does not qualify for the safe harbor provided by Revenue Procedure 2020-44, it can be treated as a deemed taxable exchange unless the modification satisfies the current rules or the 2019 Proposed Regulations to not be treated as a deemed taxable exchange.

Effect on hedging or integrated transactions

Revenue Procedure 2020-44 provides that the modification of a contract to adopt qualifying LIBOR fallback language will not be treated as a deemed taxable exchange. Accordingly, if a qualifying modification is made to a contract that is part of a hedging or integrated transaction, the modification will not result in the "legging out" or termination of the hedging or integrated transaction.

Please contact David Moldenhauer, Avrohom Gelber or James Gouwar with questions or for more information.

CONTACTS

James Gouwar
Partner

T +1 212 878 3388
E james.gouwar
@cliffordchance.com

Avrohom Gelber
Partner

T +1 212 878 3108
E avrohom.gelber
@cliffordchance.com

David Moldenhauer
Partner

T +1 212 878 8384
E david.moldenhauer
@cliffordchance.com

Rebecca Pereira
Counsel

T +1 212 878 3392
E rebecca.pereira
@cliffordchance.com

Michaela Morr
Associate

T +1 212 878 8156
E michaela.morr
@cliffordchance.com

Rebecca Hoskins
Professional Support
Lawyer

T +1 212 878 3118
E rebecca.hoskins
@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

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