IRS Revenue Procedure 2020-44: Floating Rate Fallback Flexibility from the Feds - McGuire Woods

The IRS recently released Revenue Procedure 2020-44 ("**Rev. Proc. 2020-44**") which provides helpful relief to taxpayers by providing that if a contract referencing an IBOR is modified to incorporate specific ISDA or AARC fallback language for the replacement of IBORs, such modification will not cause certain adverse tax consequences, such as exchange treatment under Section 1001 of the Tax Code, or the legging out or termination of integrated transactions under Treasury Regulation Sections 1.1275-6, 1.988-5(c) or 1.148-4(h).

This is particularly significant for tax-exempt debt instruments with a LIBOR based interest rate that may otherwise be treated as "reissued" for federal income tax purposes as a result of the addition of such language, and any derivative transactions (such as interest rate swaps) that are treated as "integrated" with a debt instrument for tax purposes.

As we wrote about here, to support the transition from IBORs the AARC published fallback language for inclusion in the terms of certain newly issued and outstanding cash products, including floating rate notes, bilateral business loans, syndicated loans, securitizations, adjustable rate mortgages, and variable rate private student loans (the "**AARC Fallbacks**"). The fallback language generally provides a mechanism for determining the replacement benchmark rate that supplants the current benchmark rate.

Likewise, on October 9, 2020 ISDA posted its Supplement number 70 to the 2006 ISDA Definitions (the "**ISDA Supplement**") to facilitate the inclusion of new IBOR transition fallback provisions in derivative transactions entered into on or after January 25, 2021, and its final ISDA IBOR Fallbacks Protocol to facilitate adoption of the ISDA Supplement by parties to legacy derivative contracts (the "**ISDA Protocol**"). An "**ISDA Fallback**" is the set of terms provided in any one of sections one through six in the Attachment to the ISDA Protocol.

On October 9, 2019, the Treasury Department and the IRS published proposed regulations on the tax consequences of modifying debt instruments, derivative contracts, and other contracts to replace IBORs or add fallback provisions to IBORs (the "**Proposed Regulations**"). The ARRC later recommended guidance on the tax consequences of modifying a contract as provided in the ISDA Protocol and AARC Fallbacks and the Treasury Department and IRS have accepted those recommendations in issuing the interim guidance in Rev. Proc. 2020-44.

Under Rev. Proc. 2020-44 certain reasonably necessary and technical deviations from the specific terms of an AARC Fallback or an ISDA Fallback are permissible.

Rev. Proc. 2020-44 is effective for modifications to contracts occurring on or after October 9, 2020 and before January 1, 2023. A taxpayer may, however, rely on Rev. Proc. 2020-44 for modifications occurring before October 9, 2020.

While this guidance is very helpful in providing taxpayers with certainty upon adding fallback language to a new or existing contract, it doesn't absolve the parties from analyzing the tax consequences of an actual transition from an IBOR to a new rate. At that point taxpayers will need to look to the guidance in the Proposed Regulations (or whatever form the guidance is in at that point) to determine the tax consequences. The Proposed Regulations currently require a new rate to be any one of several rates that are listed in the Proposed Regulations (including SOFR) and if an AARC Fallback or ISDA Fallback results in a new rate that is not on the list there could be adverse tax results.

By Robert A. Kaplan, Emery B. McRill & Kay McNab on December 8, 2020