HAWKINS ADVISORY

Some Guidance Relating To Transitions Away From LIBOR
Rev. Proc. 2020-44

I. Introduction

On October 9, 2020, the Treasury Department and the Internal Revenue Service (the "IRS") released Rev. Proc. 2020-44 ("RP 2020-44"), to allow the modification of certain contracts (including derivatives which comply with the requirements for integrated treatment under § 1.148-4(h) of the Treasury Regulations), which reference an interbank offered rate (an "IBOR") to introduce an ARRC Fallback, an ISDA Fallback (each as defined herein below) and/or certain variants of either fallback, without such modification resulting in a taxable event to the investor or issuer (i.e., an exchange of property for other property differing materially in kind or extent for purposes of § 1.1001-1(a) of the Treasury Regulations).

The contract modifications sanctioned by RP 2020-44 generally favor replacing an unrepresentative IBOR-based reference rate with the Secured Overnight Financing Rate ("SOFR"), which has been published daily by the Federal Reserve Bank of New York since April 3, 2018.

RP 2020-44 is effective for contract modifications of debt instruments and derivative contracts, among others, occurring on or after October 9, 2020, and before January 1, 2023. A taxpayer, however, may rely on this revenue procedure for contract modifications that occur before October 9, 2020. The Treasury Department and the IRS may provide additional relief as necessary to address developments in the transition away from IBORs.

II. Background

On July 27, 2017, the Financial Conduct Authority, the United Kingdom regulator and overseer of the London Interbank Offered Rate ("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. In recognition and anticipation of the disruption to the financial stability of the markets occasioned by the elimination of LIBOR, the Alternative Reference Rates Committee ("ARRC") and the International Swaps and Derivatives Association ("ISDA") worked to identify alternative reference rates intended to take the place of LIBOR and adopted proposed fallback language to facilitate an orderly phased transition away from IBORs, including LIBOR. It should be noted that LIBOR will continue to be published after the end of 2021, but may cease to be a representative reference rate after such date.

After considering a comprehensive list of alternatives, the ARRC recommended SOFR as the replacement for USD LIBOR.

ISDA developed new fallbacks based on adjusted versions of risk-free rates ("RFRs") for different affected currencies. The alternative RFRs are expected to be term- and spread-adjusted to account for the differences between IBORs and RFRs, and are expected to go into effect following a permanent discontinuation of a covered IBOR or, in the case of LIBOR, a non-representativeness determination. Bloomberg was selected as the vendor to calculate and publish the term-adjusted RFR (i.e., the RFR compounded in arrears), the spread adjustment and the "all-in" fallback rate (i.e., the term-adjusted RFR plus a spread). SOFR is generally the RFR for U.S. dollar denominated instruments.

III. Concerns Regarding the Tax Consequence of Contract Modification to Reflect Alternative Reference Rates

An important consideration regarding the modification of financial instruments to reflect the phasing out of IBORs and the replacement thereof with an alternative reference rate, is the possibility that the modification could trigger a taxable event to the holders and/or issuers of such instruments. § 1001 of the Internal Revenue Code (the "Code"), and the Treasury Regulations promulgated thereunder, set forth rules for determining whether gain or loss realized upon the exchange of property for other property differing materially either in kind or in extent must be recognized, and if so, the amount thereof.

The Treasury Department and the IRS previously determined it necessary and appropriate to provide guidance on the possible tax consequences of modifying debt instruments, derivative contracts, and other contracts in order 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 (the "Proposed Regulations").[1] The ARRC provided comments on the Proposed Regulations. In addition, the ARRC developed certain recommended fallback language intended to support the transition from USD LIBOR to an alternative reference rate (the "ARRC Fallbacks"). ISDA similarly developed supplements to operative ISDA definition documents, intended to facilitate inclusion of new fallbacks for certain key IBORs in derivatives transactions, and protocols intended to facilitate the implementation of RFRs in connection with existing documents (collectively, the "ISDA Fallbacks"). Both the ARRC Fallbacks and the ISDA Fallbacks address new contracts and

[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.

modifications of existing contracts, as well as modifications that may be occasioned by future developments in connection with applicable reference rates. The Treasury Department and the IRS have concluded that interim guidance in advance of finalizing the Proposed Regulations is needed to support the adoption of an ARRC Fallback, an ISDA Fallback, and/or certain variants thereof described below.

IV. Fallbacks Described

A. AARC Fallback.

(1) In general. An "ARRC Fallback" is contract language that is recommended by the ARRC and identified in RP 2020-44.[2] Different fallback language applies in respect of different types of contracts. An ARRC Fallback includes only those options or variants provided in the contract language identified in the relevant section. As of October 9, 2020, the ARRC Fallbacks consisted of recommended contract language for adjustable rate mortgages, bilateral business loans, floating rate notes, securitizations, syndicated loans, and variable-rate private student loans. ARRC Fallbacks are publicly available at *https://www.newyorkfed.org/arrc/fallbacks-contract-language*.

(2) Tax-Exempt Bonds. The relevant language in respect of issues of tax-exempt obligations is set forth in the section dealing with floating rate notes: 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. https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN_Fallback_Language.pdf (the "ARRC Guidance").

(3) Floating Rate Notes. The ARRC Guidance in respect of new issuances of USD LIBOR-referenced floating rate notes (FRNs) is set forth below. This language may be used in a broad range of floating rate securities issued in the capital markets, including municipal bonds. Certain drafting alternatives and related provisions are set forth in the ARRC Guidance at *Part III: User's Guide to Fallback Language for Floating Rate Notes*, which may be found in the document cited above.

(4) Benchmark Transition Events. The ARRC Guidance specifies that the implementation of the replacement reference rate is expected to be triggered by a "Benchmark Transition Event". (The ISDA Fallbacks make reference to the same concept as an "index cessation event".) The occurrence of such an event would instigate the replacement of an existing reference rate or "Benchmark" with a "Benchmark Replacement" on "Benchmark Replacement Date." The ARRC Guidance and the ISDA Fallbacks each contemplate not only the replacement of the current Benchmark, LIBOR, but also situations in which future reference rates have either been terminated or become non-representative. This Advisory is limited to the provisions applicable to the replacement of USD LIBOR.

"Benchmark Transition Event" is defined as "**a public statement or publication of information**" announcing one or more of the following events with respect to the Benchmark:

(a) the administrator of the Benchmark (the "Administrator") has ceased or will cease to provide the Benchmark, permanently or indefinitely, provided that, at the time of such statement or publication, there is no successor Administrator that will continue to provide the Benchmark; this announcement may be made by the Administrator, the regulatory supervisor for the Administrator, the central bank for the currency of the Benchmark, an insolvency official with jurisdiction over the Administrator, a resolution authority with jurisdiction over the Administrator or a court or an entity with similar insolvency or resolution authority over the Administrator (as an "Unavailable Benchmark"); or

(b) the Benchmark is no longer representative (e.g., LIBOR); this announcement must be made by the regulatory supervisor for the Administrator (as an "Unrepresentative Benchmark").

(5) Benchmark Replacement Date. The ARRC Guidance and the ISDA Fallbacks each describe the date on which the existing Benchmark is replaced for all purposes. The replacement date of an Unavailable Benchmark is the later of (a) the date of the public statement or publication and (b) the date on which the Administrator permanently or indefinitely ceases to provide the Benchmark. In the case of an Unrepresentative Benchmark, the relevant date is the date of the public statement or publication of information referenced therein.

(6) Permissible Replacements for an Unavailable or Unrepresentative Benchmark. A "Replacement Benchmark" means the "Interpolated Benchmark" (defined below); unless the Interpolated Benchmark cannot be determined as of the Benchmark Replacement Date, in which case "Benchmark Replacement" means the first alternative set forth in the order below that can be determined as of the Benchmark Replacement Date. Each Benchmark Replacement is to be supplemented by the Benchmark Replacement Adjustment, defined below, which adjustment is added to the Benchmark Replacement.

(a) Term SOFR; i.e., the forward-looking term rate for the applicable Corresponding Tenor (defined below) based on SOFR that has been selected or recommended by the relevant governmental body;

(b) Compounded SOFR; i.e., the compounded average of SOFRs for the applicable Corresponding Tenor, with the rate, or methodology for this rate, and conventions for this rate (which will be compounded in arrears with a lookback and/or suspension period as a mechanism to determine the interest amount payable prior to the end of each interest period) being established by the issuer or its designee in accordance with: (i) the rate, or methodology for this rate, and conventions for

[2] The Treasury Department and the IRS have concluded that any other fallback provisions should be evaluated under the standards provided in either the Proposed Regulations or, when published, the final regulations.

this rate selected or recommended by the relevant governmental body for determining compounded SOFR; and (ii) if, and to the extent that, the issuer or its designee determines that Compounded SOFR cannot be determined in accordance with clause (i) above, then the rate, or methodology for this rate, and conventions for this rate that have been selected by the issuer or its designee giving due consideration to any industry-accepted market practice for U.S. dollar denominated FRNs at such time;

(c) An alternative rate of interest that has been selected or recommended by the relevant governmental body as the replacement for the then current Benchmark for the applicable Corresponding Tenor;

(d) The ISDA Fallback; i.e., the rate that would apply for derivatives transactions referencing the ISDA Definitions to be effective upon the occurrence of an index cessation date with respect to the Benchmark for the applicable tenor excluding the applicable ISDA Fallback Adjustment; or

(e) The alternative rate of interest that has been selected by the issuer or its designee as the replacement for the then current Benchmark for the applicable corresponding tenor giving due consideration to any industry accepted rate of interest rate of interest as a replacement for the then current Benchmark for USD denominated FRNs.

(5) Relevant Definitions.

"Corresponding Tenor" with respect to a Benchmark Replacement means a tenor (including overnight) having approximately the same length (disregarding business day adjustment) as the applicable tenor for the then-current Benchmark.

"Interpolated Benchmark" with respect to the Benchmark means the rate determined for the Corresponding Tenor by interpolating on a linear basis between: (1) the Benchmark for the longest period for which the Benchmark is available that is shorter than the Corresponding Tenor, and (2) the Benchmark for the shortest period for which the Benchmark is available that is longer than the Corresponding Tenor.

"Benchmark Replacement Adjustment" means the first alternative set forth in the order below that can be determined by the issuer or its designee as of the Benchmark Replacement Date:

(a) the spread adjustment, or method for calculating or determining such spread adjustment, (which may be a positive or negative value or zero) that has been selected or recommended by the relevant governmental body for the applicable Benchmark Replacement prior to such replacement being adjusted;

(b) if the applicable Benchmark Replacement prior to such replacement being adjusted is equivalent to the ISDA Fallback Rate, then the ISDA Fallback Adjustment;

(c) the spread adjustment (which may be a positive or negative value or zero) that has been selected by the issuer or its designee giving due consideration to any industry-accepted spread adjustment, or method for calculating or determining such spread adjustment, for the replacement of the then-current Benchmark with the applicable Benchmark Replacement prior to such replacement being adjusted for U.S.D. denominated FRNs at such time.

"Benchmark Replacement Conforming Changes" means, with respect to any Benchmark Replacement, any technical, administrative or operational changes (including changes to the definition of "Interest Period," timing and frequency of determining rates and making payments of interest, [changes to the definition of "Corresponding Tenor" solely when such tenor is longer than the Interest Period] 8 and other administrative matters) that the issuer or its designee decides may be appropriate to reflect the adoption of such Benchmark Replacement in a manner substantially consistent with market practice.

B. ISDA Fallback.

In general. 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* (http://assets.isda.org/media/3062e7b4/08268161-pdf/) that is publicly available at https://www.isda.org as of October 9, 2020. The fallback articulated in ISDA guidance will go into effect on January 25, 2021, and will automatically amend or provide the template for parties to amend derivative contracts.

V. Permitted Modifications

Modifications described in RP 2020-44, which serve to allow a contract with terms that reference an IBOR to incorporate an ARRC Fallback or an ISDA Fallback, will not result in a sale or other disposition of such contract under § 1001 of the Code:

(1) The contract is modified to incorporate an ISDA Fallback, regardless of whether that modification results from an automatic incorporation of the fallback or a bilateral agreement between the parties to the contract;

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

(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 Fallback);

(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 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.

VI. Limited Scope of RP 2020-44

RP 2020-44 only addresses and provides guidance with respect to contract modifications effected to transition a contract from an IBOR reference rate to a permitted reference rate in accordance with an ARRC Fallback or an ISDA Fallback. Any other contract modifications are required to be analyzed under the general rules of §1001 of the Code and the Treasury Regulations promulgated thereunder.

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