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Rev. Proc. 2020-44: Interim guidance, transition from LIBOR and IBOR to alternative reference rates

The IRS released an advance version of Rev. Proc. 2020-44 to facilitate the market's transition from the London Interbank Offered Rate (LIBOR) and other interbank offered rates (IBORs) to alternative reference rates through adoption of fallback language recommended by the Alternative Reference Rates Committee (ARRC) and the International Swaps and Derivatives Association (ISDA).

In support of the ARRC's phased transition plan to assist market participants as they prepare for this transition away from IBORs, [Rev. Proc. 2020-44](#) [PDF 47 KB] provides that certain modifications to a contract with terms referencing an IBOR will not be treated as an exchange of property for other property differing materially in kind or extent for purposes of Reg. section 1.1001-1(a). For this purpose, a contract includes but is not limited to a derivative contract, a debt instrument, stock, an insurance contract, and a lease agreement.

Rev. Proc. 2020-44 also provides that such modifications will not be treated as a "legging out" of an integrated transaction, a termination of a qualified hedge or as a disposition or termination of either leg of a hedging transaction.

Reason for guidance

According to Rev. Proc. 2020-44, the IRS and Treasury Department determined that it is appropriate to provide guidance on the tax consequences of modifying debt instruments, derivative contracts, and other contracts to replace IBORs or add fallback provisions to IBORs.

In October 2019, regulations were proposed, and then in March 2020, the ARRC submitted a letter to the Treasury Department and IRS in which the ARRC provided comments on the proposed regulations. In connection with development of the ISDA Protocol, the ARRC submitted written comments to the Treasury Department and IRS (twice in December 2019, and then again once in January 2020 and once in July 2020) recommending guidance on the tax consequences of modifying a contract as provided in the ISDA Protocol. The ARRC also recommended similar guidance for the "ARRC fallbacks." For reasons detailed in the ARRC letters, the ARRC recommended issuing guidance that is separate from the proposed regulations and specific to the ARRC fallbacks and the ISDA Protocol.

Hence, Rev. Proc. 2020-44 is issued as interim guidance in advance of finalizing the proposed regulations to support the adoption of the ARRC fallbacks and the ISDA Protocol.

Guidance recommended by the ARRC

Guidance recommended under section 1001. Section 1001 provides rules for determining the amount and recognition of gain or loss from the sale or other disposition of property. Reg. section 1.1001-1(a) generally provides that gain or loss is realized upon the exchange of property for other property differing materially either in kind or in extent. In the case of a debt instrument, Reg. section 1.1001-3 provides rules for determining whether a modification of the terms of the debt instrument results in an exchange of the original debt instrument for a modified debt instrument that differs materially either in kind or in extent for purposes of Reg. section 1.1001-1(a).

The ARRC letters generally recommend guidance providing that the modification of a contract to incorporate the terms of an ARRC fallback, an ISDA fallback or certain variants of an ARRC or ISDA fallback does not result in an exchange under Reg. section 1.1001-1(a).

Guidance recommended on integrated transactions. A debt instrument and one or more derivative contracts may be treated in certain circumstances as a single, integrated instrument for certain specified purposes. For example, Reg. section 1.1275-6 describes the circumstances under which a debt instrument may be integrated with a derivative contract for the purpose of determining the amount and timing of the taxpayer's income, deduction, gain, or loss. Reg. sections 1.148-4(h) (regarding arbitrage investment restrictions on tax-exempt bonds) and 1.988-5(a) (regarding foreign currency transactions) also provide rules by which a debt instrument may be integrated with a derivative contract. Similarly, Reg. section 1.446-4 generally provides that the method of accounting used by a taxpayer for a derivative contract that qualifies as a hedging transaction must reasonably match the timing of income, deduction, gain or loss from the hedging transaction with the timing of the income, deduction, gain or loss from the item or items being hedged. The modification or termination of a derivative contract or debt instrument that is part of an integrated transaction or hedging transaction under one of the foregoing regulations may result in unfavorable tax consequences, such as accelerating the recognition of gain.

The ARRC letters recommend guidance providing that the modification of an integrated transaction or hedging transaction to incorporate the terms of an ARRC fallback, an ISDA fallback or certain variants of an ARRC or ISDA fallback of Rev. Proc. 2020-44 does not result in legging out of the integrated transaction, terminating either leg of the hedging transaction, or otherwise severing the integration authorized or required by the foregoing regulations.

Guidance provided in Rev. Proc 2020-44. The revenue procedure covers ARRC fallback language set forth in nine specifically identified provisions in ARRC published recommendations as well as any option or variant provided in this fallback language. The revenue procedure excludes any option or variant not provided in the specifically identified ARRC fallback language, even if that option or variant is recommended elsewhere by the ARRC. As of October 9, 2020, the ARRC fallbacks consist of recommended contract language for adjustable rate mortgages, bilateral business loans, floating rate notes, securitizations, syndicated loans, and variable-rate private student loans.

The ISDA fallback language covered by the revenue procedure includes the set of terms provided in sections numbered 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.

Certain deviations from the ARRC or ISDA fallback language are permitted: (1) if necessary to make the terms legally enforceable in a relevant jurisdiction; (2) to incorporate the ISDA fallback language into a contract that is not covered by the ISDA protocol; (3) to omit terms of an ARRC fallback or an ISDA fallback that cannot under any circumstances affect the operation of the modified contract; (4) 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 or ISDA fallback.

Examples provided in the revenue procedure of technical, administrative or operation terms are the definition of interest period, the timing and frequency of determining rates, and the timing and frequency of making payments of interest. Explicitly excluded is 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 the ARRC or ISDA fallback or as consideration for the modification.

With respect to integrated transactions, Rev. Proc. 2020-44 provides that a contract that is one leg of a transaction integrated under Reg. section 1.1275-6 or 1.988-5(a) and that is modified in accordance with this procedure is not treated as legging out of the integrated transaction under Reg. section 1.1275-6 or 1.988-5(a). Furthermore, a contract that is integrated under Reg. section 1.148-4(h) and modified in accordance with this revenue procedure is not treated as terminating the qualified hedge under Reg. section 1.148-4(h). And, finally, a contract that is part of a hedging transaction under Reg. section 1.446-4 and is modified in accordance with this revenue procedure is not treated as a disposition or termination of either leg of the transaction under Reg. section 1.446-4.

Rev. Proc. 2020-44 also includes definitions of terms and rules for application of this guidance.

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

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