October 17, 2019

New Guidance on "Hard Forks" and Changes from LIBOR

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Unforeseeable events not within the control of a property owner may impose adverse tax consequences. For example, financial regulators may require changes to the terms of a debt instrument that result in a deemed exchange of the existing debt instrument for a modified debt instrument, and therefore, generally, in the recognition of gain or loss. Earlier this month, the Internal Revenue Service and Treasury published guidance regarding the tax treatment of certain events not within the control of investors: (i) the transition from interbank offered rates (such as LIBOR) in debt instruments and non-debt contracts to other reference rates; and (ii) a "hard fork" with respect to cryptocurrency in which the owner receives units of new cryptocurrency.

Transition from Interbank Offered Rates

In 2017, the U.K. regulator that oversees the London interbank offered rate (LIBOR) announced that all currency and term variations of LIBOR, including U.S.-dollar LIBOR, may be phased out after 2021. Given that USD LIBOR is used extensively as a reference rate in financial instruments, U.S. organizations regulating financial markets have been conferring to identify alternative reference rates that may be used to replace USD LIBOR and that will comply with relevant financial standards.

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One rate that has been identified by the Alternative Reference Rates Committee (ARRC), a group convened by the Federal Reserve Board and the Federal Reserve Bank of New York, to replace USD LIBOR, is the Secured Overnight Financing Rate (SOFR)—a rate based on transactions in the repurchase market for U.S. Treasury obligations that is published by the New York Federal Reserve Bank.

The ARRC identified tax issues to the Treasury and IRS potentially associated with the elimination of LIBOR and other interbank offered rates (IBORs), and requested tax guidance to enable an orderly transition, with respect to financial instruments and derivatives referencing IBORs, to other reference rates such as SOFR.

In response, a notice of proposed rulemaking was published in the Federal Register on October 9, 2019 (84 FR 54068) to propose regulations addressing these issues. The preamble to the proposed regulations states that Treasury was urged to provide "broad and flexible tax guidance," and the proposed regulations are intended to minimize potential adverse tax consequences from changes in terms of financial instruments from IBORs to other reference rates.

The regulations to be amended include regulations under Internal Revenue Code (IRC) Section 1001 that address when changes to a debt instrument are considered to be a significant modification that results in a deemed exchange of the old debt instrument for a modified debt instrument, and therefore, generally, in the recognition of gain or loss. A change in the interest rate for a debt instrument by operation of the terms of the debt instrument is generally not considered a modification for these purposes. However, if no provision was made in a debt instrument for a change from an existing reference rate (such as LIBOR) to a different reference rate, such as SOFR, such a change could result in a significant modification and therefore in an exchange under the existing Section 1001 regulations.

The proposed regulations provide that, if the terms of a debt instrument (or the terms of a non-debt contract such as a derivative) are altered to replace an IBOR-referencing rate with a different reference rate, or to provide a different rate as a fallback in anticipation of the elimination of the relevant IBOR, that alteration will not result in the recognition of income under Section 1001 if the new rate is a "qualified rate" and certain other requirements are met.

Certain rates listed in the proposed regulations will generally be "qualified rates," and other rates may be added, after the proposed regulations are issued in final form, through guidance published in the Internal Revenue Bulletin. A rate determined by reference to one of the rates listed in the proposed regulations may also be a qualified rate. However, to obtain non-recognition of gain or loss, the alteration must also satisfy the requirement that the fair market value of the debt instrument or non-debt contract after the alteration be "substantially equivalent" to the fair market value of the debt instrument or non-debt contract before the alteration.

The proposed regulations provide two safe harbors to determine whether or not the "substantially equivalent" test is met. Under one of the safe harbors, the test is met if the historical average of the IBOR-referencing rate over a specified period does not differ by more than 25 basis points from the historical average of the replacement rate. An alternative safe harbor will be satisfied if the parties to the debt instrument are not related and determine, through bona fide arm's-length negotiations, that the fair market value of the pre-alteration debt instrument is substantially equivalent to the fair market value after the alteration. Any one-time payment made by one party to the other in connection with the alteration is required to be taken into account under the safe harbors in making this determination.

Other matters addressed by the proposed regulations include: an alteration to adopt a qualified rate in the context of an integrated or hedged transaction subject to the rules of Regulation Section 1.1275-6; preventing certain debt instruments "grandfathered" under regulations under IRC Section 1471 (relating to withholdable payments to foreign financial institutions) from being materially modified by reason of alterations made to replace an IBOR-referencing rate with a qualified rate; and the treatment of rate-related alterations with respect to a regular interest in a REMIC, for purposes of determining whether that interest had fixed terms on the "startup day," as required by Regulation Section 1.860G-1(a)(4).

The proposed regulations also provide that, if a one-time payment is made by a payor in connection with certain alterations described in the proposed regulations, the source and character of the one-time payment will be the same as the source and character that would otherwise apply to a payment made by the payor with respect to the debt instrument or non-debt contract that is being altered. For example, with respect to a lease of real property, a one-time payment made by the lessee to the lessor in connection with a modification described in the proposed regulations is treated as a payment of rent.

The amendments are proposed to apply, generally, to an alteration of a debt instrument or a modification of a non-debt contract that occurs after the date of publication of final regulations. However, a taxpayer may also apply the new regulations to alterations and modifications that occur before that date, provided that the taxpayer and related parties consistently apply the rules.

"Hard Forks" Relating to Cryptocurrency

"[T]o help taxpayers better understand their reporting obligations for specific transactions involving virtual currency," the IRS issued, on October 9, 2019: (i) Revenue Ruling 2019-24 (discussed below), and (ii) frequently asked questions (FAQs) that incorporate the substance of the ruling as well as other guidance previously issued (see IRS News Release 2019-167).

The new ruling addresses tax consequences that may result if cryptocurrency, a type of virtual currency with respect to which transactions are digitally recorded on a distributed ledger, undergoes a protocol change causing a permanent diversion from the existing distributed ledger (a "hard fork").

In the first situation described in the ruling, a hard fork occurs with respect to "Crypto M" as owned by "A." The hard fork results in the creation of "Crypto N," but no account owned or controlled by A is credited with the new cryptocurrency.

In the second situation described in the ruling, a hard fork occurs with respect to "Crypto R" as owned by "B." Solely by reason of B's ownership of Crypto R at the time of the hard fork, B is credited on a distributed ledger with units of "Crypto S," pursuant to a process involving the distribution of units of the new cryptocurrency to multiple taxpayers (an "airdrop").

The discussion in the ruling indicates that, in both situations, the holder retains the legacy cryptocurrency that the holder owned before the hard fork.

In the first situation, and taking into account that A did not receive any units of the new cryptocurrency arising from the hard fork, the ruling concludes (not surprisingly) that the hard fork does not result in income to A. By contrast, in the second situation, B has a new asset, units of Crypto S, following the hard fork. B must therefore include in income, as ordinary income, the fair market value of the units of Crypto S at the time the airdrop is recorded on the distributed ledger. B's basis in the Crypto S units is equal to the income B is required to recognize.

Observations

The result in the second situation in Rev. Rul. 2019-24 is less favorable than the result typically reached under IRC Section 305(a) in the somewhat analogous context of a stock split or stock dividend, where the holder of stock of a corporation who receives, say, additional shares of common stock of the same corporation pursuant to a stock split or dividend, is generally not required to recognize income by reason of the distribution of shares. However, the result in the second situation does not appear to be surprising in light of the lack of a statutory provision mandating non-recognition of gain or loss in the cryptocurrency hard fork context.

More generally, the IRS guidance discussed above illustrates that market-induced and non-consensual events may, or may not, result in the recognition of gain or loss or other immediate tax consequences, depending on the circumstances and applicable law.