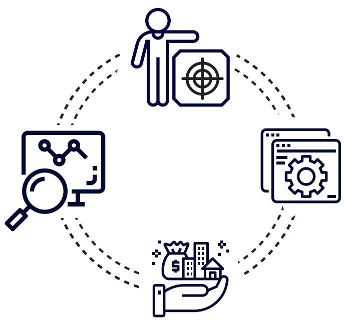
Inter-bank offered rate (IBOR) reform
Tax Considerations

IBORs, including the London Interbank Offered Rate ("LIBOR"), have a key role in financial markets and underpin trillions of dollars in notional value of financial products. However, work is underway in multiple jurisdictions to transition to alternative nearly risk-free rates ("RFRs") for the interest rate index used in calculating floating or adjustable rates for loans, bonds, derivatives and other financial contracts.

In the UK, the Financial Conduct Authority's ("FCA") intention is that at the end of 2021 it will no longer be necessary to persuade, or compel, banks to submit to LIBOR, and the Sterling Overnight Index Average ("SONIA") will be applicable to GBP-denominated FCA-regulated instruments. Likewise, other RFRs will apply globally.



As a result, new transactions are starting to be based on SONIA (indeed, c.45% of the notional value of sterling-traded swap transactions referenced SONIA in the first 6 months of 2019)[1], and non-financial corporates are now beginning to transact in SONIA, including transitioning existing financial instruments from LIBOR and entering into new loan transactions.

1 https://www.fca.org.uk/news/speeches/libor-preparing-end

Transactions entered into by non-financial corporates so far have been based on daily SONIA rates compounded in arrears, which is potentially quite different to, say, a 3-month LIBOR rate set at the start of each interest period. There remains an intention to develop term rates for SONIA.

As for legacy contracts, whilst many contracts will expire while IBORs still exist, bonds, interest rate swaps, cross currency swaps and other financial instruments continuing post-2021 will need to transition.

It is important, in assessing the overall risk and cost associated with transition, to determine whether there will be any tax impacts, driven by the legal, commercial and accounting impacts. This could include taxable amounts arising from accounts carrying value changes or 'disposal' events caused by transition, or ineffectiveness of hedging relationships. Whilst many of the impacts will relate to the timing of taxation, this is not certain to be the case - e.g., the impact of the transition on intra-group loans and derivatives, or different views taken by tax authorities to transfer pricing on transition, could cause absolute taxable amounts to arise.

Transition is coming, and without adequate advanced planning, cash and effective tax rate implications could arise, so it is vital that tax, treasury and finance departments work together on transition plans.

Summary of Key Potential Accounting Impacts and Associated Tax Considerations

Hedge accounting eligibility and effectiveness

- The proposed phasing out of IBORs post 2021 raises questions as to whether hedge accounting requirements will continue to be met for debt instruments and derivative contracts that mature after that time. Generally these require prospective assessment and where there is uncertainty as to the rates that will apply and at what time debt instruments and derivatives will transition, designated hedging relationships may cease to be effective or at least be less effective, giving rise to increased P&L volatility.
- The IASB is expected to amend IAS 39 and IFRS 9 to provide targeted reliefs from the effects of IBOR reform on particular hedge accounting requirements to alleviate the impacts noted above.
- Whether increased P&L volatility causes increased taxable profits volatility will depend on the tax residence of affected companies (i.e., the individual entities which are party to the relevant financial instruments) and the tax rules for financial instruments and hedging transactions. For example in the UK, the starting point is the P&L entries in relation to loans and derivatives, so increased P&L volatility would affect taxable profits.
- However, the application of the UK tax hedging rules, the 'Disregard Regulations', could mitigate tax volatility if a company has elected to use them, and if a 'hedging intention' continues to exist. This hedging intention would need to be reviewed if, for example, debt is priced under SONIA and derivatives are priced under LIBOR, and SONIA and LIBOR rates diverge (e.g. due to the use of daily average SONIA rates compounded in arrears, as noted above).

Modification vs derecognition of financial assets and liabilities

- The amendment of contracts to take into account IBOR reform could give rise to accounting profits or losses.
- If the terms of the modified/replacement contract are substantially different from the terms of the original contract, de-recognition and recognition of a new instrument could give rise to P&L and, consequently, taxable amounts. Even where the terms are not considered to be 'substantially modified', there may still be a modification gain/loss recognised in the P&L. The tax treatment of substantial or non-substantial modification P&L movements may be different for third party and intra-group debt instruments, and intra-group instruments could give rise to one-sided results for tax purposes. Careful consideration of the tax treatment of any such adjustment will be required.
- Where a new instrument is recognised for accounting purposes, this could result in an increased risk of separate embedded derivatives being recognised, potentially giving rise to P&L volatility. The tax treatment of embedded derivatives can be complex, so taxable profits volatility could also arise.
- The IASB are currently considering this issue amongst other issues that could have a significant impact on financial reporting as a result of IBOR reform.

Valuation and accounting impacts

- IBOR rates are often a key component of discount rates used in models to value financial and non-financial items (e.g., lease liabilities). The impact on tax carrying values and on-going tax adjustments should be considered.

Summary of Key Legal and Commercial and Associated Tax Considerations

Amendments to contracts may result in potential disposals and retesting events from a legal perspective

- Transitioning contracts (loans, derivatives, etc.) will require consideration of whether a disposal of the existing contract arises for tax purposes. If amendments are considered material, this may constitute a disposal of the existing contract and entry into a new contract for corporate income tax purposes in certain jurisdictions.
- A disposal of intra-group contracts may be treated differently to third party contracts. For intra-group contracts, a deemed market value disposal rule in the relevant tax code could crystallise a tax charge.
- Entering into a "new contract" could result in a retesting event for both accounting and tax purposes e.g., for transfer pricing purposes.
- New contracts could cease to benefit from grandfathering of historic tax treatments.

Transfer pricing policies may become inadequate

- Group transfer pricing policies may also need re-evaluating where analysis of intragroup funding is no longer based on LIBOR.
- Cross-border financing may require careful consideration where jurisdictions adopt different views on retesting the transfer pricing position (e.g., different benchmarks).
- Transfer pricing specialists should review any current and planned intra-group arrangements so that the new method of pricing is on an arm's length basis in accordance with transfer pricing rules in each relevant jurisdiction.

Tax deductibility, stamp and withholding taxes

- The new pricing basis and changes to the fair value of contracts should be reviewed to ensure that it does not give rise to excessive returns or other types of deemed (non-deductible) dividends/ distributions.
- A withholding tax review should be undertaken to ascertain whether the creation of a "new" contract requires new double tax treaty claims.
- Amending contracts could trigger stamp duties or capital taxes depending on the jurisdictions involved.
- Groups should therefore review current and planned intragroup debt ahead of transition to confirm that any structures/instruments are not at risk of non-deductibility of interest, stamp or withholding tax.

Tax /other redemption events in legal documentation

- Analysis of the Terms and Conditions in existing financial contracts will be required to examine potential impacts caused by transition of contracts, e.g., whether any tax indemnity or redemption clauses are triggered.

Other tax issues

- Groups should also consider whether there are implications for other areas of the tax code in the particular jurisdiction – for example, hybrid rules, corporate interest restriction rules and thin capitalisation rules if taxable amounts arise or change as a result of transition.

Corporate groups should identify instruments that might be affected by these tax issues; remembering that Group Treasury's concentration is likely to be on third party contracts, but intra-group items are also important for tax purposes.

In the UK, the accounting treatment is likely to be the primary driver of taxable amounts arising from and after transition, so an early review of the likely accounting impact on third party and intra-group contracts is critical. In other jurisdictions, the tax treatment may be more based on legal form.

Tax implications could arise in the form of timing differences (e.g. when profits and losses on interest rate swaps will be taxed), which can give rise to cash tax volatility, or could result in aggregate taxable amounts, e.g., on amendment of intra-group loans or due to transfer pricing disagreements between tax authorities. Therefore, early involvement of tax in the transition process, working alongside treasury and finance is critical, as most issues can be resolved with pre-emptive action.

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