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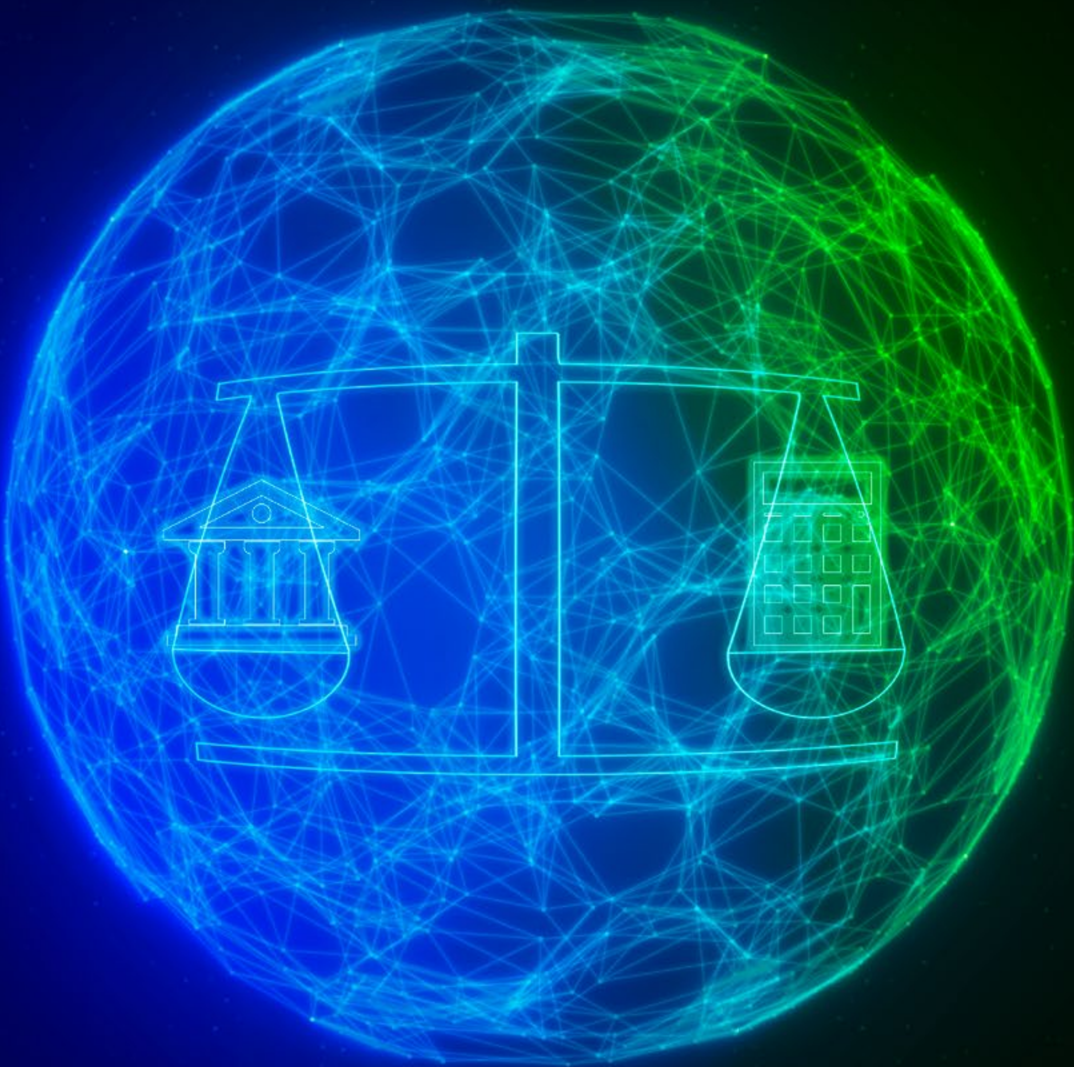

Financing and Treasury
Tax and Legal Matters

Interbank Offered Rate ("IBOR") Transition
November 2020

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Interbank Offered Rate ("IBOR") Transition

In this article, we provide a recap on the state of play of IBOR transition, and provide an overview of some of the key commercial, tax, legal, and accounting aspects that corporate groups may wish to reflect on when planning for this change.

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

IBOR Transition: The state of play

IBORs, including the London Interbank Offered Rate ("LIBOR"), have a key role in financial markets and underpin hundreds of trillions of dollars in notional value of financial products.

IBORs are currently produced in seven tenors (overnight/spot, one week, one month, two months, three months, six months, and twelve months), across five currencies (US Dollars, GB Pounds ("GBP"), Swiss Francs, Euros ("EUR") and Japanese Yen) and are based on submissions provided by a panel of contributor banks.

In July 2017, the Financial Conduct Authority ("FCA") in the UK announced that it will no longer compel banks to submit LIBOR from the end of 2021' instead of the 'sterling overnight index average ("SONIA") will be used as the alternative near risk-free rate ("AFR") for GBP denominated FCA regulated instruments.

Likewise, other AFRs will apply globally, with the USA moving to the Secured Overnight Financing Rate ("SOFR"), Switzerland moving to the Swiss Average Rate Overnight ("SARON"), Japan moving to the Tokyo Overnight Average Rate ("TONAR") and EUR LIBOR moving to the Euro short-term rate ("€STR"). EURIBOR, which is widely used in Euro denominated contracts, underwent a methodological reform in 2019 and is not scheduled to be discontinued.

Government guidance

A number of government bodies across the world have been writing to financial institutions and large businesses to encourage them to reflect on the potential impact of these changes. This includes, for example communications from the UK's FCA (letters issued in September 2018 and February 2020[1]), the United States Securities and Exchange Commission (statement issued July 2019[2]), the European Central Bank (July 2019[3]) and the Australian Securities and Investments Commission ("ASIC") (letter issued in May 2020[4]).

The Working Group on Sterling Risk-Free Reference Rates, in its factsheet of January 2020[5], encouraged businesses to 'act now', and take the following actions:

"Establish where your LIBOR exposures are … it is important to identify your exposure to LIBOR and to understand what will happen to these contracts if LIBOR is no longer available;"

"Check your contract terms … Your contracts may include "fallback" terms setting out what will happen when LIBOR is not available;"

"Familiarise yourself with SONIA, and what it means for you/your business … you/your business may need to make changes to systems…;"

"Speak to your bank, product provider, consult with a financial services professional or advisor."

It is clear, therefore, that relevant regulatory bodies are encouraging financial markets participants to engage with IBOR transition, engage with their counterparties and take necessary action well in advance of the end of 2021. This includes, for new financial instruments which mature beyond the end of 2021, either basing those on AFRs, or building in a clear and robust "fallback" mechanism to apply once IBOR rates are no longer available; and for existing financial instruments which mature after the end of 2021, incorporating such fallbacks and seeking to amend those instruments to use an AFR in good time. For derivatives, the International Swaps and Derivatives Association released a Supplement and Protocol on IBOR fallbacks, to enable counterparties to adopt these in their existing and new derivatives, on 23 October 2020.

Potential commercial implications

There are certain challenges arising from the fact that LIBOR and the AFRs are fundamentally different rates, which treasury departments will need to consider in transitioning (i.e. amending) existing financial instruments, to understand the risk of value moving between counterparties on transition.

By way of background, using GBP LIBOR and SONIA as an example, these differences include:

Overnight Rate vs Term Rate

SONIA is, as the name suggests, an overnight interest rate, whereas LIBOR is quoted for various periods such as 1 month, 3 months, 6 months etc.

This means that in the case of a LIBOR-linked loan or derivative, which references (for example) 3 month LIBOR, the interest rate is set at the *start* of each 'interest period' and is fixed for that period. There is currently no widely-used equivalent term rate based on SONIA, so the developing market convention is to calculate an interest rate based on compounding overnight (i.e. daily) SONIA rates in arrears for the interest period – which effectively means that the interest rate is set towards the *end* of each interest period, and could be very different to that 3 month LIBOR rate fixed in advance.

Forward-looking "Term SONIA Reference Rates" ("TSSRs") (e.g. a 3-month SONIA rate fixed in advance, similar to 3-month LIBOR) are in development, but the Working Group on Sterling Risk-Free Reference Rates is of the view that the compounded-in-arrears approach described above should be the norm, and the use of TSSRs should be limited in practice[6].

Backward-looking Rate vs Forward-looking Rate

As noted above, LIBOR rates are fixed in advance for an interest period, so a borrower knows what it will pay at the start of an interest period; whereas SONIA compounded-in-arrears rates are calculated towards the end of the interest period, making cash flow forecasting more challenging. To mitigate the effect of this, loan transactions based on SONIA compounded-in-arrears have tended to build in a time lag, with the interest rate for a particular interest period being calculated, typically, 5 business days in advance of the end of the period.

Spread adjustments

LIBOR is a risk-adjusted rate (it includes a risk premium for the banking sector) whereas SONIA is a near-risk free rate, and is therefore typically lower than LIBOR. In order to avoid an economic value transfer from one counterparty to the other on amending a financial instrument, there is the requirement to determine an appropriate fixed spread adjustment – i.e. an additional spread over the replacement SONIA rate, to keep the parties' economic positions the same. The spread would be calculated once, at the time the particular financial instrument is amended, and different approaches may be taken to its calculation (e.g. a forward-looking approach based on swap markets, or a historic approach based on differences between LIBOR and SONIA compounded-in-arrears).

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

Potential tax implications

Certain tax authorities have issued guidance (for example, guidance released by HMRC in the UK[7]) or rules designed to limit adverse taxation implications arising from IBOR reform where the underlying economic circumstances of a transaction remain unchanged.

However, the guidance that has been released doesn't necessarily cover all circumstances and the analysis will be fact dependent for businesses, depending on how they choose to transition, and as such any guidance will not be a substitute for a specific analysis of the potential impact of the transition. Also, in territories where guidance has not yet been provided on the tax implications, uncertainty generally remains over the potential impact.

It is therefore important that taxpayers work through the legal and accounting implications in each relevant jurisdiction and the consequent tax analysis, to determine whether there could be any significant tax consequences resulting from the transition (whether through amendment of existing contracts, the operation of existing "fallback" mechanisms within those contracts, or the cessation of existing contracts and entry into replacements).

This is in relation to financial instruments with third party counterparties, intra-group financial instruments (loans, derivatives, cash pooling facilities/agreements, etc.), and other contracts which make reference to LIBOR rates (e.g. leases, other commercial contracts).In particular, it will be important to consider specific taxing rules in the jurisdictions of the counterparties to contracts – including both (or all) sides of intragroup arrangements. There may be mismatches which arise on transactions affecting different jurisdictions, and even in some cases on transactions between two group companies in the same jurisdiction.

Consideration should be given to whether:

- Transitioning contracts results in a disposal of the existing contract for tax purposes (which might follow the legal analysis);
- Amending, or terminating and replacing, contracts results in the recognition of profits or losses for accounting purposes;
- Any changes to contracts could result in the discontinuance of historic tax treatments (e.g. positions agreed with local tax authorities, or legislation which only applies to contracts entered into before a particular date);
- New double tax treaty claims, or domestic exemption claims, are required for withholding tax purposes;
- Existing hedge accounting relationships could either be broken, or become less effective, potentially resulting in more volatile taxable profits;
- The timing of transition could lead to mismatches between hedged items and hedging instruments for the purposes of specific tax-hedging rules, leading to tax volatility;

- Any stamp or capital duties, capital gains taxes, financial transactions taxes, or other indirect taxes arise; and/or

- There is any impact on interest deductibility calculations, e.g. with respect to any local implementation of the OECD BEPS Action 2 (hybrid mismatch) or Action 4 (corporate interest restriction) rules.

It may be the case that any tax consequences only result in a timing difference, with the tax impact being spread over the remaining life of the instrument in question, but in some cases the tax costs may be permanent. In either case, taxpayers should consider the potential cash flow implications.

In particular, we note that it will be important for tax departments to ensure that the transition programme considers intragroup, as well as third party, arrangements, to avoid any unexpected one-sided tax positions. As a general point, adverse tax implications can often be mitigated through action taken in advance, so it is important for group tax departments to have an involvement in the overall organisation's transition plans from an early stage.

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Transfer pricing considerations
Further, consideration should be given to whether a new testing point is created for transfer pricing purposes. Again, in some countries, tax authorities have helpfully confirmed that they are unlikely to consider that a new testing point is created where there has been no change to the underlying economic circumstances of the transactions, although this may not be the case if groups make other changes to instruments at the same time as transitioning away from IBOR (which could also result in accounting implications, as described below).

Also, it is possible that there will be jurisdictions that take a different view of the transfer pricing position and a mismatch of tax treatment may result. In such instances, where double taxation arises, it may be possible for taxpayers to consider whether they can request the competent authorities to go through the Mutual Agreement Procedure under any relevant double tax treaty in order to eliminate that double taxation.

Groups should also be aware that, even where no new testing point is created for transfer pricing purposes, there may be complexities in benchmarking new internal rates or performing comparability adjustments to new external rates. Transfer pricing documentation and treasury policy documents will need to be updated for the changes and any agreements with tax authorities which are underpinned with IBORs will need to be revisited. Groups should allow sufficient time in their compliance process in order to complete this additional work.

Potential legal implications
Consideration needs to be given to all existing legal agreements entered into by the group, internal/intra-group as well as external/with non-group entities, in order to determine which of those will be affected by the transition.

It may be obvious where an agreement is affected, for example if the agreement explicitly refers to an IBOR rate; alternatively, terms that are based on IBORs may be silently embedded within the agreement, for example if the agreement refers to a bank rate that in practice is derived from IBOR.

For affected agreements that mature after the end of 2021, a strategy should be developed. For new arrangements which are, initially, still based on an IBOR, it is important to consider introducing fallback language which will set out what will happen with any future discontinuation of the specified rate.

The strategy for dealing with existing agreements should include:

- a review of all legal agreements to determine whether those potentially affected include a fallback clause, stating the position in the event of an unavailable reference rate. If there is a fallback clause, determine whether the position will be acceptable or needs to be amended;

- consideration of whether any action needs to be taken; and

- where action is required, determination of the replacement rate and confirmation that there are no other potential impacts caused by transition of contracts, e.g. tax indemnities or redemption clauses.

Once all existing contracts have been identified, and before any amendments are made to agreements, it will be important to confirm the accounting and tax implications of any proposed amendments.

It may be that technology solutions could be used to speed up both the document identification process, as well as any amendment exercises. Groups may also want to take this time to consider implementing a contract repository system, if they do not have one already, to capture the legal data so that it is easier to identify and review in the future.

Potential accounting implications

In addition to the wide-ranging business impact, transition away from IBORs can give rise to accounting challenges for financial instruments. The International Accounting Standards Board ("IASB") have identified two groups of accounting issues that could impact financial reporting and have issued amendments to deal with these issues. The amendments enable entities to reflect the effects of transitioning from benchmark interest rates such as IBORs to alternative benchmark interest rates without this having an impact from an accounting perspective that would not provide useful information to the users of financial statements.

The IASB concluded on Phase I of the project on 26 September 2019 by publishing Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7[8]). The amendments were effective from 1 Jan 2020 and addressed issues affecting financial reporting in the period before terms of financial instruments are modified. The IASB concluded on Phase II of the project on 27 August 2020 by publishing Interest Rate Benchmark Reform – Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16).

The amendments are effective for annual periods beginning on or after 1 January 2021, with earlier application permitted. The amendments apply to all entities and are not optional. Phase II seeks to address issues that might affect financial reporting when an existing interest rate benchmark is either reformed or replaced.

We focus in this article on the Phase II amendments only. Given the pervasive nature of hedges involving IBOR-based contracts, the reliefs could affect companies across a variety of industries. We summarise the key amendments below:

Changes in the basis for determining the contractual cash flows as a result of IBOR reform under IFRS 9	The amendments provide specific guidance on how to treat financial assets and financial liabilities where the basis for determining the contractual cash flows changes as a result of interest rate benchmark reform. This can include cases where the contractual terms are amended, cases where the contractual terms are not amended but, for example, where the method for calculating the interest rate benchmark is altered, and cases where an existing contractual term is activated, such as when a fallback clause is triggered. As a practical expedient, the amendments require an entity to apply IFRS 9:B5.4.5, which means that the change in the basis for determining the contractual cash flows is applied prospectively by revising the effective interest rate. This effectively means that a profit or loss is unlikely to arise on the change itself, where the practical expedient applies. This practical expedient only applies when the change in the basis for determining the contractual cash flows is necessary as a direct consequence of interest rate benchmark reform, and the new basis for determining the contractual cash flows is economically equivalent to the previous basis (i.e. the basis immediately preceding the change). Where other changes to the contractual cash flows are made, which are not necessary as a direct consequence of benchmark reform, the usual accounting principles apply in determining the impact of such changes – meaning that profits and losses could arise, which could also have tax implications. The amendments provide a non-exhaustive list of examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis: a. The replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an alternative benchmark rate or implementation of a reform of an interest rate benchmark by changing the method used to calculate the interest rate benchmark, with the addition of a fixed spread necessary to compensate for the basis difference between the existing interest rate benchmark and the alternative benchmark rate; b. Changes to the reset period, reset dates or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and c. The addition of a fallback provision.

Hedge accounting	The amendments to IFRS 9 and IAS 39 introduce an exception to the existing requirements so that changes in the formal designation and documentation of a hedge accounting relationship that are needed to reflect the changes required by interest rate benchmark reform do not result in the discontinuation of hedge accounting or the designation of a new hedging relationship. These changes to the hedge relationship must be made by the end of the reporting period during which a change required by interest rate benchmark reform occurs and are only permitted as part of a continuing hedge relationship if certain conditions are met. The exception applies to the changes to the hedge designation that are limited to one or more of the following changes: a. Designating an alternative benchmark rate (contractually or non-contractually specified) as a hedged risk; b. Amending the description of the hedged item, including the description of the designated portion of the cash flows or fair value being hedged; c. Amending the description of the hedging instrument; and d. For those applying IAS 39, amending the description of how the entity will assess hedge effectiveness.
Modification of lease liabilities	Given the similarity of financial liabilities in IFRS 9 and lease liabilities in IFRS 16, a similar practical expedient as set out above for financial assets and financial liabilities is available under IFRS 16. It only applies when the interest rate benchmark on which lease payments are based is changed as a direct consequence of interest rate benchmark reform and the change is done on an economically equivalent basis.
Disclosures	Amendments to IFRS 7 require that an entity provides disclosures that enable a user to understand the nature and extent of risks arising from interest rate benchmark reform, how the entity is managing those risks, its progress in completing the transition from interest rate benchmarks to alternative benchmark interest rates, and how it is managing the transition. To achieve these objectives, an entity is required to disclose: • How it is managing the transition to alternative benchmark rates, its progress at the reporting date and the risks to which it is exposed arising from financial instruments because of the transition; • Disaggregated by significant interest rate benchmark subject to interest rate benchmark reform, quantitative information about financial instruments that have yet to transition to an alternative benchmark rate as at the end of the reporting period, showing separately: non-derivative financial assets, non-derivative financial liabilities, and derivatives; and • If the reform has resulted in changes to an entity's risk management strategy, a description of those changes.

The amendments are welcome, to lessen the potential accounting impacts of interest rate benchmark reform and to simplify the accounting treatment.

Given that in many jurisdictions (such as the UK), the taxation of financial instruments is based on the accounting treatment (subject to computational rules which can supplement or over-ride it), the amendments should help lessen the tax impact in those jurisdictions as well – but it is important to confirm the accounting analysis in advance of transition, so that relevant action can be taken if adverse tax implications could arise.

Overall considerations

There are a variety of considerations for businesses with respect to the tax, legal and accounting aspects arising from IBOR transition. It is therefore recommended that tax, legal and accounting personnel (to the extent that they have not done so already) explore the various considerations together and draw up an action plan to ensure that the group is fully prepared for transition.

Typically, such a plan will first involve understanding the progress on the transitioning of external instruments and internal systems and then working through the various other considerations, and timelines to achieve this work. Given that 2021 is fast-approaching, companies need to act now, to improve the prospects of a smooth transition, and mitigate the risks of adverse consequences.

Endnotes

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