Analysis

IBOR transition: are you ready?

Speed read

Interbank offered rates (IBORs) are interest rate benchmarks that underpin a huge number of loans and derivatives. The majority of London interbank offered rates (LIBORs) will be discontinued at the end of 2021. In assessing the overall risk and cost associated with transition away from IBORs, businesses should determine the potential tax implications, which could include taxable amounts arising from accounts carrying value changes or 'disposal' events caused by transition, ineffectiveness of hedging relationships for tax purposes, and transfer pricing considerations. Businesses should consider now any actions that could reduce the risk of adverse tax outcomes.

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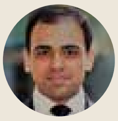

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Interbank offered rates (IBORs), including London interbank offered rates (LIBORs), are used as the reference interest rate in hundreds of trillions of dollars in notional value of loans and derivatives globally.

In July 2017, the UK Financial Conduct Authority (FCA) announced that it will no longer compel banks to submit LIBOR from the end of 2021, and replacement reference interest rates have been developed for the five LIBOR currencies (US dollar, sterling, Swiss franc, the euro and Japanese yen). The sterling overnight index average (SONIA) is the alternative risk-free rate (RFR) for sterling-denominated financial instruments.

Given their prevalence, most companies will have contracts that reference LIBOR and, if those contracts mature after the end of 2021 (June 2023 for some US dollar rates), will need to take some action to 'transition' them to refer to an RFR. Whilst loans and derivatives are the most commonly affected transactions, and are the principal focus of this article, other contracts (including leases and other operational contracts) may include LIBOR references, and transition will be required for relevant intra-group contracts, as well as those with unconnected parties.

Amendments to contracts could have accounting, tax and transfer pricing implications. In this article, we provide an overview of some of those implications, and actions that companies may wish to consider.

Wider context and developments

Timing

On 5 March 2021, the FCA announced that publication of most LIBOR rates will cease from 31 December 2021. Most US dollar LIBORs will continue to be published until 30 June 2023, to allow contracts maturing before that time to run off. For sterling transactions which mature after 2021, market participants are expected to not enter into new LIBOR-based contracts after Q1 2021 and either actively transition existing contracts or incorporate suitable 'fallback' provisions by the end of Q3 2021.

Therefore, over the next few months, companies will need to complete their transition plans for relevant LIBOR-based contracts. Certain instruments may already contain contractual fallback provisions under which LIBOR rates are automatically replaced at a set future date. For example, the International Swaps and Derivatives Association has published automatic fallbacks to the new RFRs, which can apply to pre-existing derivatives if the counterparties so choose.

Accounting updates

Following the initial announcements by the FCA, the International Accounting Standards Board (IASB) identified two groups of financial reporting issues and has made amendments to accounting standards.

The IASB's 'phase I' amendments were effective from 1 January 2020. They addressed issues affecting financial reporting in the period before financial instruments are modified, providing temporary exceptions to specific hedge accounting requirements, to avoid entities having to discontinue hedging relationships solely due to the uncertainty arising from the reform.

The 'phase II' amendments are effective from 1 January 2021 (with early application permitted). They seek to address the accounting challenges arising at transition. The amendments introduce a practical expedient for modifications to financial assets, financial liabilities and leases required as a direct consequence of IBOR reform (including making consequent changes to keep the parties' economic positions the same; for example to change the spread over the reference interest rate). These modifications are accounted for by updating the effective interest rate, which should reduce the likelihood of material profit and loss impact. The amendments also provide that hedge accounting is not discontinued solely because of IBOR reform (albeit some hedge ineffectiveness could arise, as described in the 'hedging' section below).

The Financial Reporting Council has published equivalent changes to UK GAAP.

It is important to understand this accounting context, as the taxation of financial instruments for UK companies is based on the accounting, subject to special computational provisions, as discussed below.

Corporation tax implications

Accounting gains and losses

HMRC has released helpful guidance on IBOR reform on

Gov.uk (*Tax implications from the withdrawal of LIBOR and other benchmark rate reforms* (updated 12 January 2021), see bit.ly/2SB5vu3), to which we refer as relevant below.

For UK companies, the general rule under CTA 2009 Parts 5 and 7 is that amounts brought into account for tax purposes in respect of loan relationships and derivative contracts are the amounts recognised in the profit and loss account. Therefore, a key question is whether amendments to financial instruments to transition to RFRs will have a profit and loss impact for a company.

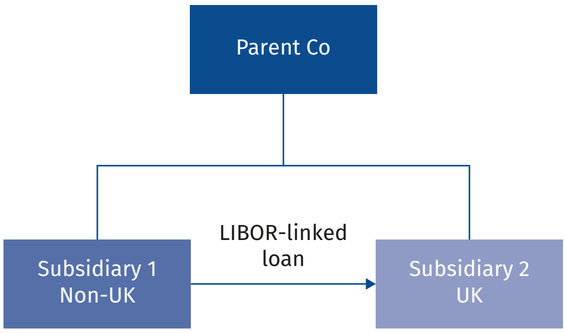
The amendments to accounting standards described above are intended to limit circumstances that give rise to profits and losses where a loan is amended to reflect only changes required for IBOR transition. (The position is somewhat different for derivatives, given that these are generally accounted for at fair value; see the 'hedging' section below.)

HMRC refers to the accounting amendments in its guidance. The general expectation is that, where a loan is simply being amended to refer to a new reference rate with consequential changes to keep the parties' economic positions the same, material profits and losses (and therefore corporation tax impacts) should not arise.

However, where other changes are made to a loan – for example, where the interest rate is 'rebased' to market or the maturity date changes – it is possible that accounting profits and losses relating to these changes could be recognised, which could lead to an immediate impact on taxable profits. This would then be expected to reverse over the term of the financial instrument.

This could apply to loans with unconnected third parties and to intragroup loans – with the possibility of tax mismatches arising on the latter. These could arise on cross-border loans if there is a mismatch in the tax treatment of any gain or loss between group companies (for example, due to different accounting approaches or different taxing regimes, such as an accounts basis versus legal form).

Example: Consider the following example where there is a UK borrower and potential modification gains and losses.



In this example, Subsidiary 2 could view the amendment of the LIBOR-linked loan as an accounting modification giving rise to a profit, whereas Subsidiary 1 may not see any change to the instrument under local law. As a result, Subsidiary 2 may have an accounting gain on transition, to reduce the carrying value of its liability, followed by increased finance costs over time as the loan accretes back to par value; whereas Subsidiary 1 may continue to recognise the same amount of finance income.

Over the life of the loan, the aggregate taxable or deductible amounts should in theory be equal in the two companies; however, rules such as 'hybrid mismatch' provisions could potentially give rise to absolute tax costs: in the above example, annual finance cost deductions in Subsidiary 2 exceed taxable finance income in Subsidiary 1, leading to difficult questions under the UK's hybrid rules (TIOPA 2010 Part 6A), such as whether this mismatch arises as a result of the terms of the financial instrument and whether the initial profit in Subsidiary 2 can be considered 'ordinary [i.e. taxable] income' in respect of those increased finance costs (s 259CB).

HMRC's guidance acknowledges that hybrid mismatches could arise as a result of IBOR reform, albeit comments are limited to considering timing mismatches between counterparties (for example, deductible payments in one party, with taxation in the counterparty arising in later periods).

There appears to be little tax authority guidance on IBOR reform in many jurisdictions, leading to uncertainty as to whether tax mismatches on cross-border intragroup loans could arise. Our April 2021 survey of 35 jurisdictions revealed that only three of those jurisdictions – the UK, Japan and the US – have any formal tax authority guidance or rules. In the US, proposed rules have been released in relation to whether IBOR reform could cause a 'substantial modification' of a financial instrument, or affect tax hedging relationships.

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Even in a wholly UK context, it is possible that tax mismatches could arise. For example, if Subsidiary 1 in the example above was a UK company, an accounting loss might not be deductible for tax purposes, as it arises from a 'related transaction' in a 'connected companies loan relationship' (CTA 2009 s 352). The accounting gain in Subsidiary 2 could remain taxable. Such a mismatch should reverse over the life of the loan, but there could be a timing disadvantage.

In summary, the accounting amendments should be helpful in reducing the potential for immediate profits and losses to arise from IBOR reform, but it is important that tax practitioners carefully consider the impact in all affected jurisdictions.

Hedging and hedge accounting

It is common for LIBOR-based instruments to be part of hedging relationships – potentially on both sides, for example where a company has LIBOR-interest debt and an interest rate swap to effectively convert this into fixed interest.

Under the accounting amendments referred to above, hedge accounting is not discontinued provided any changes to the hedging instrument or hedged item are a direct consequence of IBOR reform. An element of hedge ineffectiveness (i.e. profit and loss volatility) could arise, for example where the loan and the derivative are amended at different times (which is likely to be common, given that instruments are often with different counterparties) or on different terms.

This could flow through to volatility in taxable profits, depending on the application of the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations, SI 2004/3256 (the 'Disregard Regulations'). For companies that have elected to apply the Disregard Regulations to their interest rate derivatives, reg 9 can mitigate taxable profits volatility, even where there is increased accounting volatility. Where hedge accounting has not been adopted, though, the question arises as to whether the 'hedging relationship' continues to exist throughout for the purposes of reg 9, given the potential for derivatives and debt instruments to transition at different times.

Any such time gap will likely be driven by commercial negotiations with counterparties, and companies' hedging intentions in relation to the relevant debts and derivatives would generally be expected to remain in place. HMRC's guidance says that in such circumstances, where the hedging intention continues throughout, companies can continue to apply the Disregard Regulations to the hedging relationship uninterrupted – even if there is an element of economic ineffectiveness in the hedging relationship due to the time gap. It will be important for companies relying on reg 9 to clearly document their continuing hedging intentions.

For companies that have not elected into the Disregard Regulations, but instead rely on hedge accounting to reduce accounting and taxable profits volatility, any increased hedge accounting ineffectiveness would increase taxable profits volatility. Designated fair value hedges (broadly, for swapping fixed rate debt into floating) often cannot fall within the Disregard Regulations and so any profit and loss volatility would be expected to flow through to taxable profits.

The legal form of IBOR transition, in respect of a derivative, could also influence the tax treatment. For derivatives which already fall within reg 9, no net profits or losses would be expected to arise on IBOR transition itself, whether the derivative is amended or terminated and replaced (in the latter circumstance, this may require spreading of an equal and opposite gain/loss on termination and 'cost' of the replacement contract: reg 9(4)). A termination and replacement might afford a company the opportunity to elect into reg 9 for the 'replacement' contract, to reduce taxable profits volatility going forward.

In summary, the taxation of hedging transactions can be complex, and IBOR reform could lead to some increased accounting and taxable profits volatility depending on a company's specific circumstances, but HMRC's guidance provides comfort that 'tax hedging' relationships can continue.

Disposals of contracts

It may be important to consider whether amending a financial instrument could trigger the 'disposal' of the existing contract and the creation of a new contract, particularly in jurisdictions which tax on a legal form basis, meaning that fair value gains and losses could be crystallised on a 'termination'.

This could also be relevant from a UK tax perspective. Whether changes to a contract constitute termination or variation of that contract may not be clear, and it will be important to ascertain the legal documentation and intentions of the parties. HMRC states in its guidance that where the parties to a contract amend it purely to replace LIBOR with an RFR and to equalise the economic position, this would typically be considered a continuation of the existing contract.

This could be relevant to matters including:

- the validity of double tax treaty clearances to pay interest at treaty rates of withholding, or application of the double taxation treaty passport scheme;
- whether 'grandfathered' tax treatments continue to apply (for example, certain F(No.2)A 2015 Sch 7 changes to the loan relationships and derivatives contracts rules apply only to instruments entered into in an accounting period beginning on or after 1 January 2016); or
- whether interest on a newly issued 'security' could be in excess of a reasonable commercial return and therefore treated as a distribution (CTA 2010 s 1000(1)E), or the security treated as 'equity' for the purposes of tax grouping rules (such as CTA 2010 s 162).

HMRC's guidance is helpful, in that simply changing an instrument to give effect to LIBOR reform is not expected to result in issues such as the above. Further consideration will be required if companies take the opportunity to change other terms of their financial instruments, and also to determine the position in other jurisdictions (for example, with regards to double tax treaty application).

Therefore, it will be important for companies to understand the legal documentation of, and intentions behind, IBOR transition transactions. Tax practitioners should ensure they are involved in discussions with accounting and legal colleagues, so that the potential tax consequences can be appropriately considered.

Proposed legislation

The current Finance (No.2) Bill 2021 introduces two legislative provisions in response to IBOR transition:

- The first removes references to LIBOR in CAA 2001 s 70O and s 228MB, and CTA 2010 s 437C. These relate to leasing transactions. They currently refer to 12-month LIBOR as a fallback rate but this will be amended to refer to a company's 'incremental borrowing rate' (taking its accounting meaning). These are not widely used provisions, so the impact of the change should be limited.
- The second change gives the Treasury powers to make provision by regulations about the tax consequences of things done in connection with LIBOR (and other reference rate) reform, including to change the tax treatment of transactions – potentially with retrospective effect. We understand that no regulations are currently expected to be made under this power; rather, it is intended to give flexibility in the event that unforeseen issues arise.

Transfer pricing

IBOR reform gives rise to a number of transfer pricing considerations for both instruments that are pre-existing at the date of transition and the pricing of new instruments between related parties.

HMRC guidance acknowledges that parties to a contract referencing IBOR 'would, acting at arm's length, agree to make changes to the contract to respond to the reform of the benchmark'. These changes should be made on an arm's length basis in accordance with OECD transfer pricing guidelines, and groups should hold documentation to reflect the impact of the withdrawal of IBOR on their transfer pricing policies.

As such, taxpayers will need to consider what represents an acceptable arm's length standard, and there are various nuances to be considered in this regard, including:

- **The chosen rate:** The Bank of England and the FCA have made it clear that they anticipate the majority of the sterling market to move to overnight SONIA compounded in arrears. The natural starting point for a transfer pricing analysis may be to consider arrangements to transition third party debt within the taxpayer's group, which may well involve a move to an RFR compounded in arrears. However, this is different to what groups may be used to when using IBORs, which are forward-looking rates published for a number of tenors. When using backward-looking rates such as SONIA compounded in arrears, borrowers would not have certainty of cash flows, as the calculation of interest takes place shortly in advance of the end of the payment period, rather than at the start.

Bearing such points in mind, the Working Group on Sterling Risk-Free Reference Rates acknowledges that 'term SONIA' may be appropriate in some limited circumstances, such as where certainty of payments is important operationally, and so borrowers may wish to consider such alternatives in an intra-group context.

- **Economic equivalence:** Transitioning from IBOR to an RFR is unlikely to be an economically neutral transaction, absent making other adjustments – for example, IBORs incorporate a credit risk premium, whereas RFRs are generally near risk-free rates. In order to maintain the economics of historic transactions or methodologies, groups may wish to increase the margin that has been historically applied over the IBOR base rate, using available market data on such 'spread adjustments'.
- **Re-testing point:** On contracts that are being amended for IBOR transition, HMRC advises that 'it would not normally be necessary to reassess whether the terms of the original agreement are arm's length as this is tested at the point that the provision was originally entered into'. However, we expect that this will only be the case where an instrument is solely amended for the rate change. If companies take the opportunity to amend other terms of the instrument, such as extending the maturity date, this might necessitate a re-evaluation of the borrowing from a transfer pricing perspective. Furthermore, as noted above, there is limited guidance in many jurisdictions, and it may be the case that even a simple amendment of the interest rate causes the need to re-test an instrument in a counterparty jurisdiction.

There are a number of transfer pricing considerations arising from IBOR transition, ranging from elements such as those set out above which cover the rates to use going forward, and the impact of transitional adjustments on existing contracts, through to data sources for new rates, systems changes, and the need to consider transition on a global basis for multinational groups.

Other matters

HMRC's guidance also covers matters including withholding tax and VAT implications of any compensatory payments made between counterparties, various reporting requirements, stamp duty and stamp duty reserve tax, and the impact on clearances.

Conclusions and next steps

LIBOR reform has been on treasurers' agendas for several years, but we are now in the home stretch with transactions to enter into new RFR-based contracts and transition existing contracts happening regularly. Recently introduced accounting amendments and HMRC's guidance helpfully clarify the possible tax effects, but the potential for adverse tax outcomes remains.

Tax professionals should work with their treasury, accounting and legal colleagues to understand and plan transition transactions, including for intra-group contracts (which may not be high on treasurers' agendas but still carry the risk of cross-jurisdictional tax mismatches), and they should be part of any IBOR reform working groups.

It may be possible to manage the risk of adverse tax outcomes, but it is important to consider this in advance of transactions happening and, given that we are already past Q1 2021, the time to act is now. ■

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- Tax implications of LIBOR discontinuation (R Sultman & B English, 28.3.19)