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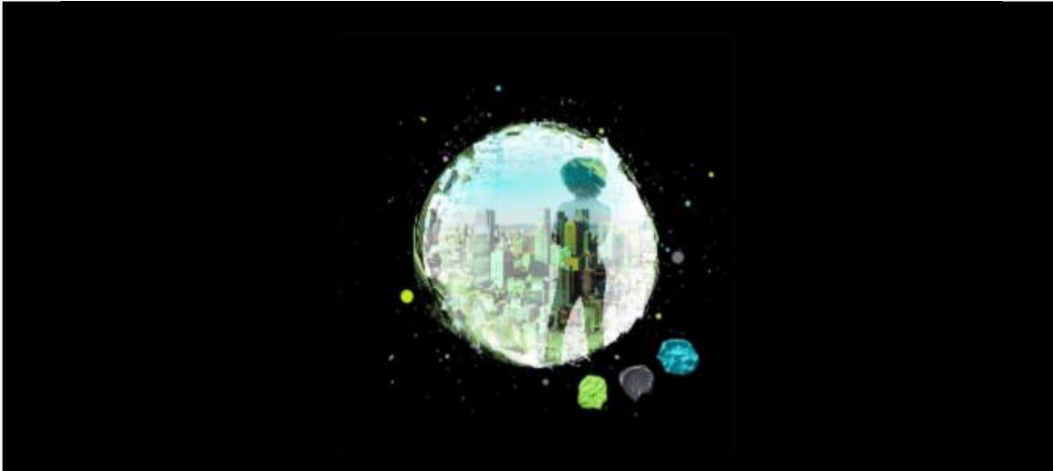

Deloitte Africa Tax & Legal
Transfer Pricing Alert

Keeping you up to date on the latest transfer pricing developments impacting your business

Interbank offered rate (IBOR) transition

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

IBORs are benchmark interest rates which major global banks lend to one another in the international interbank market for short-term loans, and consist of the following:

- published on a daily basis for tenors ranging from overnight to 12 months
- calculated by averaging panel banks submissions
- the main categories of products using IBORs are loans, bonds, floating-rate notes (FRNs), derivatives, structured products, etc.
- broadly used across institutions to price products, as discounting factor to value assets (e.g. collateral), as benchmark performance and in treasury/risk processes/intercompany agreements.

In July 2017, the Financial Conduct Authority (FCA) in the United Kingdom announced that it would no longer compel banks to submit The London Inter-bank Offered Rate (LIBOR) from the end of 2021 and recommended the use of the "Sterling Overnight Index Average" (SONIA) as the alternative risk-free rate (AFR) for pound sterling (GBP) denominated FCA regulated instruments. Similarly, other AFRs will apply globally with the United States moving to the "Secured Overnight Funding Rate" (SOFR), Switzerland moving to the "Swiss Average Rate Overnight" (SARON), Japan moving to the Tokyo Overnight Average Rate (TONAR) and LIBOR denominated in Euros (EUR LIBOR) moving to the Euro Short-Term Rate (ESTR). Furthermore, the Euro Interbank Offered Rate (EURIBOR), which is

widely used in Euro denominated contracts, underwent a methodological reform in 2019 and is not scheduled to discontinue.

The potential commercial implications include the fact that LIBOR and 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. An example using the GBP LIBOR and SONIA can be illustrated as follows:

- Overnight rate vs term rate
  SONIA is regarded as an overnight interest rate whereas LIBOR is quoted for various products such as one month, three months, six months, etc. This means that in the case of the LIBOR-linked loan or derivative, which references, e.g. three months, 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 the 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 vary differently to that three month LIBOR rate fixed in advance.

  Forward looking Term SONIA Reference Rates (TSSRs), e.g. three-month SONIA rate fixed in advance, similar to three-month LIBOR, are in development but the working group is of the view that the compounded-in-arrears approach discussed above, should be the norm and the use of the TSSRs should be limited in practice.

- Backward-looking rate vs forward-looking rate
  As noted above, LIBOR rates are fixed in advance for an interest period so the borrower knows what it will pay at the start of the 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, five 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 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 a requirement to determine an appropriate fixed spread adjustment – that is, an additional spread over the replacement SONIA rate, to keep the parties' economic position the same. The spread would be calculated once, at the time the particular instrument is amended, and different approaches may be taken to its calculation, for example, forward-looking approach based on swap markets or historical approach based on the difference between LIBOR and SONIA compounded-in-arrears.

Transfer pricing consideration

- The Organisation for Economic Co-operation and Development's (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
  As per chapter IX of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the **termination and/or substantial renegotiation of existing arrangements may be perceived as business restructuring and may have to be compensated at arm's length,** if such termination and/or substantial renegotiation would be compensated between independent parties in comparable circumstances.

As a consequence, before amending existing contracts (e.g. loans or derivatives), companies should consider whether this could:

- give rise to a disposal of the existing contract for tax and transfer pricing purposes
- result in step ups/downs of the principal amounts under consideration
- require once-off payments in relation to the changes
- impact the effective margins applied to the arrangements under consideration
- long-term funding contracts based on IBOR (which extend beyond 2021) should already take the transition into account.

Where intra-group IBOR funding is being replaced or novated, companies should check that the new method of pricing is on arm's length basis in accordance with transfer pricing rules, so as to ensure there are no tax return adjustments to deny the deductibility of financing expenses.

Furthermore, 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 have been no changes to the underlying economic circumstances of the transactions, although this may not be the case if a multi-national group of companies make other changes to instruments at the same time as the transitioning away from IBOR.

Multi-national group companies 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 IBOR transition, as well as any agreements with tax authorities which are underpinned with IBOR will need to be revisited. Multi-national group companies should allow sufficient time in their compliance process in order to complete this additional work.

Ensuring a seamless IBOR transition requires a holistic approach covering all aspects of the transition:

Exposure assessment	Identification and review of arrangements potentia the IBOR transition from a tax and transfer pricing
Risk mitigation	Evaluation of the tax and transfer pricing risks arrangements impacted by the IBOR transition anc transition roadmap to mitigate these risks.
Operational readiness	Implementation support to ensure a compliant from a tax and transfer pricing perspective inc pricing documentation and contract remediation.

Overall considerations

There are a variety of considerations for businesses with respect to the tax, legal and accounting aspects arising from the IBOR transition. It is, therefore, recommended that tax, legal and accounting personnel explore the various considerations together and draw up an action plan to ensure that multi-national group companies are 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 as well as timelines to achieve this work. Given that 2021 is fast-approaching, companies need to act now, to improve the prospects of smooth transaction and mitigate the risks of adverse consequences.

Contact us

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Resources that would be of interest to you

- Transfer pricing in a downturn – Navigating volatility
- Updates on transfer pricing developments
- Deloitte's 2020 Guide to fiscal information: Key economies in Africa
- **Deloitte School of Tax & Legal** – Register for our latest online training courses.
- Visit the **Deloitte COVID-19 Tax & Financial Measures microsite** here and access a high-level summary of tax and fiscal COVID-19 measures that have been announced by governments.
- **Deloitte tax@hand –** Get timely COVID-19 global and regional tax news, information and resources as developed by Deloitte firms around the world. Subscribe and access the site here.
- **COVID-19 Signal Topic Alerts –** Stay up-to-date with the latest government tax and fiscal responses to COVID-19. To sign up to receive Signal Topic Alerts, email signal@deloitte.com.

- GoWork – COVID-19 Immigration Digital Map - Provides information in real time, so companies can access the most up-to-date information on travel restrictions, quarantine and immigration in relation to COVID-19.

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