Katten

TAX ADVISORY

Tax Implications of LIBOR Reform

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LIBOR (London Interbank Offered Rate) is a set of interest rate benchmarks based on the rates at which banks are willing to borrow wholesale-unsecured funds. It is used in numerous financial instruments such as loans, derivatives and other financial products, as well as leases. The LIBOR reform aims to address the weaknesses in the benchmark rate, including past efforts to "*fix*" the rate.

In March 2021, the Financial Conduct Authority (FCA) and the ICE Benchmark Administration, the administrator of LIBOR, announced that sterling, euro, Swiss franc and Japanese yen LIBOR panels, as well as panels for one-week and two-month US dollar LIBOR, will cease at the end of 2021, with the remaining US dollar LIBOR panels ceasing at the end of June 2023. The announcement reiterates to firms and market participants the need to prepare for and complete the transition from (non-US dollar) LIBOR by the end of 2021. This will include affected parties either amending the terms of existing instruments that use LIBOR or replacing them with new instruments that do not use LIBOR. In doing so, firms should be aware of the tax implications.

Various existing interest rate benchmarks could replace LIBOR in a financial instrument. The Sterling Risk Free Rate Working Group has recommended Sterling Overnight Index Average (SONIA) as its preferred alternative risk-free rate (RFR) to replace sterling LIBOR. For US dollar LIBOR, Secured Overnight Financing Rate (SOFR) has been recommended as the replacement RFR.

The Finance Bill 2021

Following a HM Revenue & Customs (HMRC) consultation, and its subsequent responses, the government has published draft legislation in the Finance Bill 2021 to address the discontinuation of LIBOR and the reform of other benchmark rates. This includes the replacement of statutory references to LIBOR with "*incremental borrowing rate*" in leasing provisions with effect from 1 January 2022. The draft legislation also introduces a time-limited power to allow any unintended tax consequences arising from the transition away from LIBOR and other benchmark rates to be addressed in secondary legislation.

HMRC Guidance

HMRC has issued guidance regarding the potential UK tax implications of the benchmark reform (Guidance). The Guidance applies equally to LIBOR and other benchmark rates that are also being withdrawn or reformed. It applies where amendments replace the benchmark rate, introduce or amend fallback provisions, or make incidental amendments that are consequential to replacing the benchmark rate. Contracts may be amended by direct negotiation, changes to a bank's standard terms and conditions, a clearing house's rulebook or through the parties adopting industry standard language, such as adhering to the International Swaps and Derivatives Association (ISDA) Protocol to amend legacy contracts. It is expected that in the majority of cases the changes to the instrument as a result of the benchmark reform will be minor and the economics of the transaction will be largely maintained.

If a financial instrument's terms are amended, the way this is treated in the accounts of the parties could impact the tax treatment. As a general rule, amounts recognised in a company's profit or loss arising from its financial instruments are brought into account for tax purposes under the loan relationship and/or derivative contract rules (at Parts 5 and 7 of the Corporation Tax Act 2009 respectively). However, in some specific circumstances,

the tax treatment deviates from the accounting treatment, for example, where the parties to a lending transaction are connected companies the loan is treated for tax purposes as if it were held on an amortised cost basis of accounting. Different rules apply for businesses that are subject to income tax. However, where a financial instrument is taken out for the purposes of a trade or property business, the tax treatment will generally follow the accounting treatment.

Given this, under both corporation tax and income tax rules, where loan or derivative terms are amended to use a new RFR, the tax treatment will usually depend on the accounts. Where amounts are recognised in the income statement, these will typically be brought into account for tax purposes, although as noted above there can be exceptions to this treatment. Where the amendment of a loan or derivative does not change the amounts recognised in the income statement, there should not generally be any impact on income tax or corporation tax for the business.

To determine the tax position, it may be necessary to determine whether a financial instrument that is amended as a result of the benchmark reform constitutes:

- the continuation of an existing financial instrument (i.e., variation of the original); or
- the creation of a new financial instrument.

In the first case, where parties amend the terms of an instrument due to the cessation of LIBOR, HMRC would normally view this as a variation of the existing financial instrument and hence the amended contract should be treated as the same contract, entered into at the same time as the original one. Provided the economics of the transaction remain broadly the same, it does not matter if the spread on the instrument needs to be amended slightly or if there are additional payments between the parties. This means that generally LIBOR-cessation related amendments should be viewed as a continuation of the existing instrument.

Given this, HMRC has provided detail on certain situations where considering whether there has been a variation of the original financial instrument or the creation of a new financial instrument will be relevant and to assist in determining whether there are any tax implications:

- ***Fallback provisions:*** where the existing agreement contains fallback provisions, this should not be regarded as an amendment to the existing contract and, therefore, it would not be necessary to consider whether a new contract is created — we would expect loans entered into using the post-November 2014 Loan Market Association documentation to be regarded as a continuation of an existing financial instrument as this documentation contains fallback provisions;
- ***The Disregard Regulations (S.I. 2004/3256):*** these will continue to apply provided the intention to hedge remains;
- ***Grandfathering:*** grandfathering provisions would normally be expected to continue. For example, the qualifying old loan relationship rules that only apply to loans entered into on or before 12 May 2016;
- ***Additional payments to compensate for amendments to the terms:*** the nature of the payment needs to be considered, including the nature of the legacy contract and which party is making the payment;
- ***Hybrid mismatch:*** where the payee includes the payment in a later period, companies may claim, under Part 6A of the Taxation International and Other Provisions Act 2010, for the permitted period to be a later period of the payee where it is just and reasonable for the amount of ordinary income to arise for that taxable period rather than an earlier period. Non-statutory clearances may be made for this;
- ***Double taxation treaty passport scheme:*** such changes would not amount to a material change and there is no need to contact HMRC;
- ***Reporting requirements:*** no reporting requirements will be triggered under EU Mandatory Reporting Rules (DAC6) and the International Movement of Capital regulations. However, consideration is required for Bank, Building Society Interest and Other Interest returns where additional payments are made;
- ***Loan capital exemption for stamp duty and stamp duty reserve tax:*** there should be no impact on this exemption as it is tested at the point that the right to interest is created and, therefore, it would typically not be necessary to revisit this;

- ***Company distributions:*** such amendments would not themselves constitute a material change that should alter existing distributions analysis;
- ***Equity holder status:*** such changes by themselves should not have any impact on the question of whether a loan carries more than a reasonable commercial return for this purpose; and
- ***UK transfer pricing rules:*** no requirement to reassess whether the terms of the original agreement are arm's length as this would have been tested when the provision was originally entered and HMRC expects the arm's length nature of the transaction to be preserved where market standard terms are used for the amendment.

Firms may request HMRC clearance on the tax treatment of an arrangement to obtain certainty as to the effect of an amendment related to the benchmark reform. Existing clearances may continue to be relied upon provided the amendment to the financial instrument does not affect the broad economics of the transactions and there is no significant tax analysis that would be affected by the amendments. If the changes were wider and had a material impact on the transaction, HMRC would no longer be bound by the clearance.

A company can also apply to HMRC for an Advance Thin Capitalisation Agreement (which sets out the terms on which HMRC will accept that the company's interest payments represent an arm's length cost of borrowing for a specified period) if they are concerned the transfer pricing rules might be used on a proposed funding arrangement, for example, where an intra-group loan is entered into.

The cessation of LIBOR (and other benchmark rates) means that firms need to amend or replace agreements that reference such rates. HMRC's guidance can be used to assist in determining whether an amendment to the terms of a financial instrument as a result of the benchmark reform will require a re-analysis of the tax implications of the transaction. Generally, the tax impact of such changes will depend on the accounting treatment.

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