Keeping up with Tax Banking and Capital Markets

October 2019

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Introduction

Welcome to October's edition of Keeping up with Tax Banking and Capital Markets, picking up on a range of current hot topics relevant to our industry. We have gathered input from a number of specialists across our Banking & Capital Markets tax team in putting this together and we hope you find it interesting and useful.

In this edition, we have six articles covering the following areas:

- A discussion on the suggested SDRT reforms by the Labour Party and the impact this will have on the Financial Services Sector should they come to fruition.
- A summary of how the Financial Services exemption for the Digital Services Tax works and how it could potentially impact businesses when it is in force.
- An update from our August seminar hosted by the PwC Financial Services Tax Accounting Services team which focused on themes in the interim reporting season and other developments including ESMA's recent guidance on deferred tax recognition, and IFRS 16 and IFRIC 23.
- Guidelines on how to submit R&D claims efficiently given the slow-processing of some claims by HMRC.
- A summary of the Government's response to the off-payroll working rules consultation and the associated draft Finance Bill clauses, and the changes coming into force from April 2020.
- A discussion of the potential tax and other implications of the proposed new interbank reference rates being proposed as a replacement for LIBOR.

I hope you enjoy the articles. Please get in touch with me or your regular PwC contacts if there is anything that you would like to discuss further. Please let us know if there are any topics that you would like us to cover in upcoming editions. We are also keen to hear your feedback on this newsletter so would welcome any thoughts or comments.

Kind regards,

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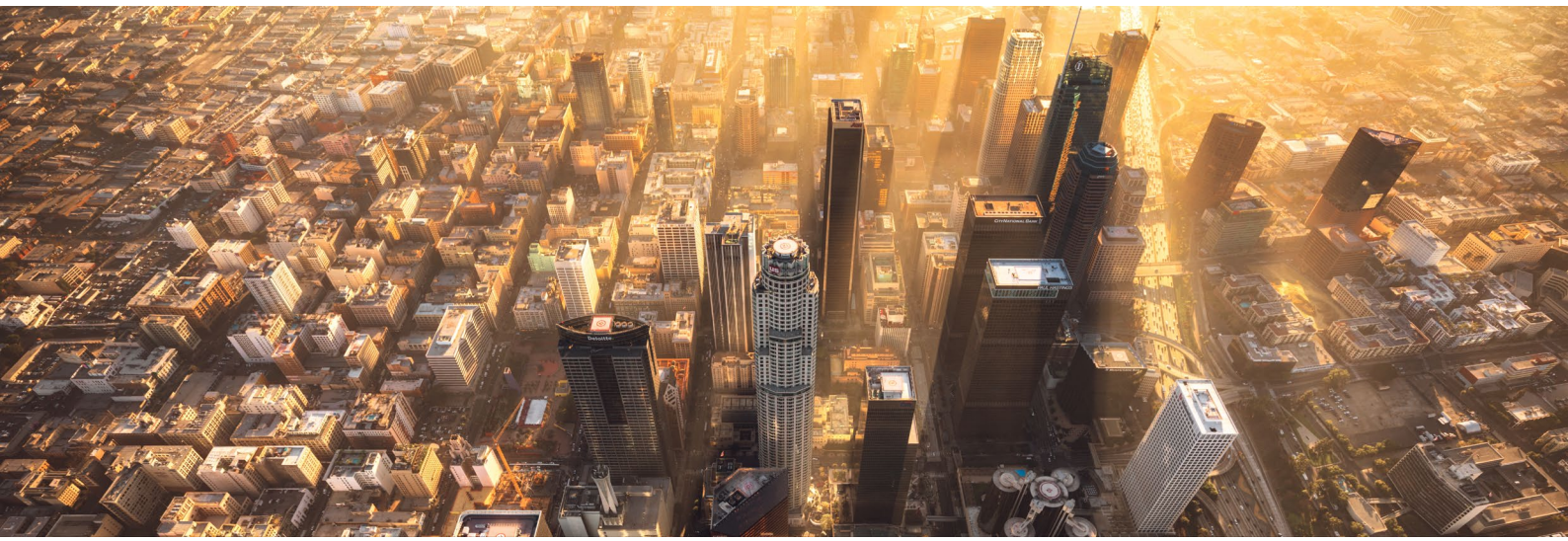

Labour Party Proposal for SDRT Regime Reform

In brief

Earlier this month John McDonnell, the Shadow Chancellor of the Exchequer in the Labour Party, endorsed proposals for major reform of the UK's Stamp Duty Reserve Tax ("SDRT") regime, the UK tax regime that accounts for the majority of UK stamp tax collected on securities transactions. If implemented these changes would certainly be the most significant to the regime since its introduction more than 30 years ago.

These proposals are based on recommendations by a group called Intelligence Capital. Previous recommendations from this group formed the basis for Labour's manifesto commitment in 2017 to extend the scope of SDRT.

These latest changes are comprehensive and complex. However the key features can be distilled down into four main areas: a significant expansion of the products within the scope of SDRT, a residence basis of taxation for specific product types, the removal of exemptions currently relied upon by parts of the financial services sector and some major changes to the SDRT collection machinery.

Even if the Labour Party was to come into power in the UK there would be a number of significant practical hurdles to overcome in order for this proposed regime to come into effect, which likely means that the chance of these changes coming into force in the short term is very low. That said, the breadth of the proposals and the stated policy rationale for the changes provide some clear indications of Labour's approach to the taxation of the capital markets sector.

In detail

Context

For a number of years the Labour Party has proposed reform of the UK's SDRT regime. In 2015 the Party proposed certain restrictions of the availability of intermediary relief, the exemption from SDRT available to dealers in in-scope securities.

In the Labour Party's 2017 manifesto, a more fundamental reform of the SDRT regime was proposed. The proposals, based on a paper by Professor Avinash Persaud of Intelligence Capital, included an expansion of the products within the scope of SDRT from (broadly) equities and certain 'equity-like' debt to include fixed income securities, as well as credit and equity derivatives. The 2017 proposals also included the removal of intermediary relief, replacing it with a reduced rate of 0.2% on equity transactions (as compared with the standard rate of SDRT of 0.5%).

Less attention was placed on what was arguably a more fundamental change to the tax: the application of SDRT on non-equity products on a residence basis (i.e. taxing UK tax residents entering into in-scope transactions) rather than the issuance basis that currently applies (i.e. taxing based on where the securities concerned are issued).

Current proposals

The proposals announced last month are effectively a commitment to implement further recommendations made by Intelligence Capital. These recommendations build on the 2017 proposals and include a further expansion of the products in scope, a retention of the residence basis of taxation for certain products and some further suggestions on the design of the collection and compliance machinery required to implement the regime. The key features of the proposals are set out below.

1. Extension of scope

Under the latest proposals, the current scope of SDRT would be extended to include a much broader range of products, including corporate debt, equity derivatives, credit derivatives, interest rate derivatives, spot FX transactions, currency derivatives, and spot and derivative transactions over certain commodities.

Experience from other regimes that have introduced taxation of non-equity products (such as the derivatives tax introduced within the Italian Financial Transaction Tax regime) has demonstrated the challenges that result: issues that arise include defining the tax point (e.g. whether to tax the entering into of derivatives, the modification of derivatives, etc.) and determining the amount subject to tax.

To further complicate matters, the rates of tax under the proposals vary by product type and vary between financial firms and non-financial firms (the Intelligence Capital report does not go as far as providing any definition of a 'financial firm' for these purposes). For example, interest rate derivatives would be taxed at a rate of 0.03% for non-financial firms and 0.01% for financial firms, whereas spot commodity transactions would be taxed at rates of 0.12% and 0.04%.

2. A residence basis of taxation

The 2019 Intelligence Capital report retains the recommendation from the 2017 report of taxing non-equity products based on the residence of the party to the transaction rather than where the product is issued. Specifically, it is proposed that the taxes applying to non-equity products will apply to UK tax residents only.

The report discusses the risk of migration of activity from the UK in response to such a tax and provides various reasons as to why this should not happen. That said this would clearly represent a very significant departure from the current application of the tax, which is a tax applying to any purchaser of (broadly) UK issued securities, regardless of a purchaser's tax residence, to a tax applying only to UK tax residents (at least in respect of non-equity products).

Labour Party Proposal for SDRT Regime Reform (cont'd)

3. Removal of exemptions

As noted above the Labour Party has in the past expressed concerns with the application of intermediary relief. In common with the 2017 report, these latest proposals include a removal of this exemption (with reduced rates of tax payable by financial firms, as noted above).

No mention is made in the report of other exemptions currently relied upon by the financial services sector, such as stock lending relief for example, but it is probably fair to assume that such exemptions would also be removed. Removal of these exemptions and intermediary relief would clearly have a significant impact on the SDRT charges arising to securities dealers.

4. Collection and compliance machinery

The primary mechanism for collection of SDRT is CREST, the UK's settlement system. This reflects the current scope of the regime as limited (largely) to equity products. The proposed expansion in the scope of the tax necessitates a new approach to collection of the tax and the report includes some outline proposals in this respect.

For certain products the report proposes collection through existing financial market infrastructure, such as the Continuous Linked Settlement Bank for foreign exchange transactions. For other product types the report proposes the filing of tax returns by UK tax residents, with data in returns reconciled to market data provided by market infrastructure providers (such as the London Clearing House for interest rate swap products).

If implemented this regime would therefore result in new and very significant compliance obligations not only for institutions trading in-scope products but also for relevant market infrastructure providers as well.

What do these proposals mean for Labour's tax policy?

It can be seen from the above that any such reform would be a very significant change to the current scope of SDRT. Leaving aside the political dimensions to these proposals coming into force, there would be substantial practical obstacles to implementing such a radical charge to SDRT. For these reasons alone it is unlikely that these proposals would come into force any time soon.

That said, the endorsement of the Intelligence Capital report by the Labour Party is important in providing an indication of the Party's proposals for taxation of participants in the capital markets sector, including the following:

- The report's rationale for reforming SDRT is to reduce what is described as 'transactions-led finance', including what the report describes as short term, excessive trading in financial products. The report includes some estimates of the likely increase in tax take, but the justification in the report is much more focused on changing how the UK's financial markets operate rather than increasing tax collected. This indicates that the Labour Party sees taxation as a way of changing behaviour within the capital markets.
- The endorsement of the residence principle in the report shows that the Labour Party is prepared to levy new taxes on securities transactions that will apply only to UK tax residents, notwithstanding the potential impact on competiveness of the UK financial sector.
- It is also clear that Labour's tax policy in this area is not only of relevance to financial (and non-financial) institutions who are trading in-scope products themselves – other parts of the financial services sector, and notably market infrastructure providers, could well be affected by the collection machinery suggested in the report and should therefore take an interest in what's being proposed in this area.

The takeaway

The proposals endorsed by the Labour Party clearly represent a very major reform of the UK's SDRT regime and reflect a continuation the Party's focus on this tax over recent years. Whilst the practical challenges of implementation alone mean that we're unlikely to see these changes in the short term (leaving aside the political considerations), the proposals are worthy of attention for their breadth of impact across financial services and what they tell us about Labour's policy to taxation of the capital markets sector.

Let's talk

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Financial Services Exclusion – Digital Services Tax

In brief

Draft legislation for the UK's Digital Services Tax ("DST") was included in the 2019-20 Finance Bill published on 11 July 2019. The broad outline of these rules is that UK digital services revenues arising in a period (less a £25m allowance) are taxed at 2% from 1 April 2020. UK digital services revenues are revenues from **search engines**, **social media platforms** and **online marketplaces** which derive value from UK users.

This is subject to a threshold test that £500m of global revenues must be generated from relevant activities of which £25m relates to revenues generated from the UK.

In detail

The definition of **online marketplaces** is drafted very broadly. Given the nature of some financial services activities (e.g. trading platforms, investment management platforms, insurance platforms, etc.) it is likely that without an exemption these activities would be impacted by the online marketplace inclusion.

An online marketplace, for these purposes, is defined as an online platform, where;

- the main purpose, or one of the main purposes, of the platform is to facilitate the sale by users of particular things; and
- the platform enables users to sell particular things on the platform to other users, or to advertise or otherwise offer to other users particular things for sale.

Given that HM Treasury's policy intention is that DST will not impact financial services, the draft DST legislation includes a proposed exclusion for "Online Financial Marketplaces".

In overview, an "Online Financial Marketplace" is excluded from these rules, if;

- it is provided by a **financial services provider;** and
- more than half of the relevant revenues arise in connection with the provider's facilitation of the trading or creation of **financial assets.**

The definition of a **financial services provider** is assessed against certain UK regulatory criteria – where a business is regulated it is more likely to be exempt; where it is not regulated it is highly unlikely to qualify for the exemption. Given that DST can be applied to non-UK regulated businesses there is also a provision which extends the exemption to corresponding overseas regulatory regimes.

Concerns with the currently drafted exclusion for "Online Financial Marketplaces"

The current drafting of the "Online Financial Marketplace" exclusion leaves uncertainty on how the exclusion should work in practice and does not exempt certain financial services activity. Examples of this include:

Financial Services Exclusion – Digital Services Tax (cont'd)

- There are certain products which are not or may not always be "**financial assets**". These include (but are not limited to) oil futures, gas futures, commodities trading, carbon credits, forward FX, spot FX and crypto-assets (including cryptocurrencies). Cash is also unlikely to be a "financial asset", and it is likely that some transactions in cash may fall outside the "payment service provider" exemption.
- There may also be some services which are not covered by the "**financial services provider**" exemption because the relevant services are not currently considered as regulated activities in the UK. For instance, operating a payment application on a mobile phone might not currently constitute a "payment service" for regulatory purposes but could come within the broad definition of "**online marketplace**" in the DST rules.
- Whilst the definition of "**financial services provider**" is broad, it does not include certain businesses which are not themselves regulated. For example, where an entity is relying on a regulatory permission of another group entity as an appointed representative of that entity, that appointed representative would likely not qualify for the exemption.
- The DST is levied at **group level** and then the liability for payment is allocated between entities, but the exemption applies to **individual companies** at an activity level. This inconsistency gives uncertainty over how it should be applied in practice, in particular where an affiliate of the provider is regulated, but the provider itself is not.
- Regulated persons trading on unregulated platforms could also fall outside the financial services exemption as currently drafted. Examples of unregulated platforms are online bulletin boards or price comparison sites, which do "facilitate the sale by users of particular things" but are generally not required to be authorised persons or a recognised investment exchange since they do not support the execution of transactions.
- Where the business is not UK resident it is necessary to determine whether the non-UK activities correspond to UK activities in determining whether the **financial services provider** definition is met. It is not clear how this determination should be made, e.g. corresponding in terms of effect, intention, context, etc. or in all possible ways.

The takeaway

In conclusion, whilst the "Online Financial Marketplace" exemption from the DST is welcome, additional updates and clarifications are needed to ensure this operates as intended. HM Treasury has closed a consultation into these rules in early September. Following this, it is hoped that legislative and guidance updates will be made in relation to the issues raised above although it is not expected that all of the above points will be closed off.

The intention of this law is to act as an interim measure until multilateral reform is introduced. In June 2019 the OECD approved a work plan for 2019/20 with the intention for a consensus solution to be agreed by December 2020 in relation to these matters. Therefore, whilst the DST is intended to be an interim measure it is likely to apply until 2021 or maybe beyond. It is possible that the rapid development of financial services provision through technology could cause further challenges with DST even in the period before conversion to an OECD regime.

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Financial Services Tax Reporting Update Seminar

In brief

In August we held the Summer instalment of our regular series of webexes and seminars on tax accounting current affairs of most relevance to the financial services sector. As many Financial Services businesses (particularly Banks) tend to have calendar year ends, the Summer is often when we focus on how tax is reflected in half year reporting.

In our update this quarter we considered themes in interim reporting season and other developments including ESMA's recent guidance on deferred tax recognition, and two accounting standards which apply to many Groups for the first time in FY19 - IFRS 16 and IFRIC 23.

In detail

The key themes we discussed were as follows:

Tax and interim reporting

Interim reporting for tax can be tricky and judgemental - IAS 34 requires a forecast of full year tax rate to be applied to interim results. That in turn requires good quality forecasts of both accounting and taxable profits. While conceptually this shouldn't lead to a dramatically different result from preparing an actuals based calculation to the results of a half year, in volatile times and less predictable business models in our advisory and audit work we regularly see examples where this is not the case.

Examples of features that can drive differences include :

1. The banking surcharge allowance which can have a significant impact on the company or branch's full year effective tax rate; and
2. Movements in material unpredictable non-deductible amounts or provisions (such as regulatory fines or customer compensation).

In practice we've historically seen clients adopt a hybrid approach to interim reporting - a top down forecast that is sense checked through an actuals based calculation for the quarter or half.

However, with pressure towards tighter close timelines (and particularly in the financial services sector with regulatory and other pressures at interim periods) we are seeing a shift toward streamlining processes - technology enabled granular reliable forecasting that works for tax purposes, and can reduce man hours around interim reporting as a result. Tax is notoriously last to finish, and we are seeing more institutions investing in solutions for tax reporting that can meaningfully shorten close timetables overall.

Financial Services Tax Reporting Update Seminar

To spread or not to spread?

In both our audit of tax and tax accounting advisory roles for interim reporting we typically spend time considering what tax adjusting items are discrete (and should therefore sit in a particular period) vs. items where the ETR impact should be spread across a period as a whole. Typical examples include -

1. Prior Year Adjustments;
2. Changes around Uncertain Tax Provisions;
3. DTA recognition or derecognition; or,
4. A change of law (taking into account the rules on substantive enactment).

While US GAAP is clear on what represents a discrete item, IAS 34 is not so prescriptive. For most items our Guidance and Manual permits either approach.

Volatility in the ETR is getting more attention from analysts and other internal and external stakeholders, and so we are seeing more debate as a result. Clearly the decision to spread or not to spread can have a big impact. Of course, wherever there's an element of choice as auditors we want to see that you have a clear Group policy that's consistently applied between periods.

A focus on deferred tax

In July we saw ESMA release a public statement on deferred tax and its expectations on deferred tax asset recognition, as well as its intention to continue to pay particular attention to this issue while reviewing financial statements. The statement reinforces the importance of robust evidence in support of all deferred tax assets (i.e., not just the ones related to losses) where an entity has unrelieved losses brought forward. So yet more pressure on good quality entity by entity forecasts.

The report also highlights the importance of disclosures - which should be as specific as possible to the circumstances of the particular issuer. While there is nothing new in the ESMA announcement, it confirms the continued focus on tax accounting from a number of sources.

The impact of changes to the lease accounting standard

IFRS 16 impacts lessees for periods beginning on or after 1 January 2019, and can drive changes to deferred tax balances and the ETR (particularly for global Groups). If you haven't worked through this in detail so far, the slides from our update contain further detail on the potential tax considerations of IFRS16 adoption as well as a worked example of the application of the modified retrospective application on leases. Please do let us know if you would like a copy of these slides.

Uncertain tax positions

IFRIC 23 applies for accounting periods beginning on or after 1 January 2019, and our experience (both with IFRIC 23 and on adoption of the equivalent US standard FIN 48) is that it is easy to underestimate the importance of good documentation around uncertain tax positions, and also the time that it can take to prepare! We'd strongly recommend that Groups take time to document and agree positions with their auditors prior to year-end wherever possible.

If you would like to be included on our mailing list for future events, or to discuss any of the themes included in this event further, please do not hesitate to contact one of the contacts listed below, or your usual PwC contact.

Let's talk

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IR35 Government Update

In brief

It's official - the Government has now published its response to the off-payroll working rules consultation and associated draft Finance Bill clauses, with the changes coming into force from April 2020. This doesn't leave organisations much time to understand how the changes will impact them and prepare for them.

Broadly, the rules for the Private Sector and Public Sector will generally be aligned in treatment, (other than for small Private Sector businesses which will be exempt).

In detail

Some of the key areas organisations are currently focusing on can be distilled as follows:

1. Who makes the IR35 assessment?

End users are responsible for making the IR35 assessments and they will be required to provide a copy of the determination, and the rationale, to the contractor. The contractor has the right of appeal and if the end user does not respond quickly enough they can be liable for the employer National Insurance Contributions (NICs). Where there are many agencies in the supply chain, the responsibility can still flow back to the end user so clear auditable processes are required. New rules around who is responsible for assessing status under IR35 apply from April 2020 but who is footing the bill? With confirmation that responsibility for determining employment status is being moved to the end user, many businesses are trying to understand the implications of managing this in practice.

2. Who bears the costs?

Most of the companies (end users) that we are advising do not have the capacity to absorb additional labour costs. Even if the company engages their Personal Service Company (PSC) contractors via an agency, a managed service provider or third party supplier, they should expect the additional costs to be passed on to them. In some cases, contractors might dispute their IR35 status (for example, if they have a clause in their contract giving them the right to provide a substitute). However, tribunals have held that the mere inclusion of this right is not in itself sufficient and it must either have been exercised or is capable of being exercised in practice (e.g. the end client would genuinely accept a substitute). We expect that many end users will take a more conservative approach to determining the IR35 tax status than the individual might have previously concluded via their PSC. To illustrate the financial impact, let's say the contractor was earning £100,000 pa, the cost impact for the end user could be as much as £20,000 pa. Additional costs incurred would include employer NIC (13.8%) and the apprenticeship levy (0.5%). The contractor might seek to increase their rate to offset their own lost benefits and tax efficiency. The total difference could easily be 20% or more if you add additional costs and charges. If the end user is to avoid this additional cost they will need to reassess their contingent worker policies and ways of working, and they may have to reduce their contractor rates. This could equate to a fairly sizeable pay cut for many contractors.

IR35 Government Update (cont'd)

3. How do you organise your workforce?

Faced with the prospect of reduced take home pay, many contractors will wish to explore alternative engagement arrangements with their end user companies. For our clients, maintaining labour flexibility and agility, without increasing labour costs disproportionately or compromising on risk, will be key to their business models and ability to retain competitiveness. Moving quickly to a new flexible workforce structure or alternative contingent labour strategy should provide a market advantage and attract the best labour force.

4. What's the impact for the private sector of the upcoming changes?

Increased costs

Any change in the tax treatment of these workers will have a financial impact on businesses (minimally, an increase of c.14% to cover employers NIC and apprenticeship levy, plus operational costs (such as administration costs, agency margins etc.). These additional costs may flow back to the business so it is encouraged to start looking at the financial implications and model the potential impact (with or without the added cost of employment rights such as holiday pay). On that basis, there will need to be a review of potential engagement models for the contingent workforce.

- ***Contractor rates:*** Contractors may look to gross up their rates for PAYE and NIC.
- ***Processes and controls:*** Updates will need to be made to current documentation and processes involved in these arrangements (such as payroll, AP invoicing, HR) which adds further complexity.
- ***Procurement:*** There will need to be a review of current contractual arrangements whilst ensuring the company remains financially competitive to the contingent workforce.
- ***VAT recovery:*** Partial VAT recovery, especially in the FS industry, may mean that costs of contractor engagements in comparison to other engagement options are comparable. Financial modelling is being undertaken to understand how costs can be managed.

The takeaway

With large amounts of regulation in the banking industry alongside the change management projects (e.g. Brexit, MiFID II, IFRS 17), there has been a large influx of contingent workers performing certain roles. As such, organisations are having to be relatively proactive in determining the most efficient way of structuring their engagement models. A noticeable sticking point for the industry is the intention to maintain a cost neutral position in light of these changes. Some potential options being considered include:

- Assessing the need for positions and streamlining the engagement of contractors, by removing any non-essential roles;
- Placing contractors on the payroll, where under the rules it would be required, but with the additional costs absorbed by the contractors engaged;
- Drafting contracts with the inclusion of the relevant indemnities;
- Considering whether all engagements are done through an agency or managed service provider, where their obligations will be limited to assessing the individual and providing the associated status determination statement; or,
- Renegotiating contractor rates, thereby freeing up cash for the additional remittances (i.e. Class 1 Secondary NIC and Apprenticeship Levy).

From a strategic and commercial perspective this is proving particularly problematic and banks will likely have to land on a hybrid solution.

Let's talk

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R&D claims - ensure efficient processing of claims by submitting sufficient documentation

In brief

Financial Services is increasingly a technology based industry, with technical innovation being key to businesses across the sector. Technical innovation is not just limited to 'FinTech' companies, with traditional financial institutions investing heavily in technology in order to increase efficiency, provide scale, and meet regulatory requirements. This investment in technology may well qualify for R&D credits and companies should be looking to identify qualifying R&D activities and costs to make the most of these valuable credits.

Given a huge surge in R&D claims, it's unsurprising that there have been significant delays in the processing of R&D claims by HMRC - therefore it is essential that the right documentation is submitted to help ensure claims are processed as quickly as possible.

In detail

As a reminder, for entities other than SMEs, Research and Development Expenditure Credits (RDEC) give a benefit of 12% 'above the line' credit, or a 10% cash value after tax on qualifying costs such as staff costs (including salaries, bonuses, employer pension and social security), software and consumer items, externally provided workers and subcontracted payments. Examples of eligible activities PwC have successfully claimed include technical development relating to implementation of increasingly complex risk, fraud analysis and valuation engines, and implementing systems to comply with enhanced regulatory requirements such as MiFID II and GDPR.

Recent Developments

HMRC recently launched an online form for submitting R&D documentation and, as part of this, confirmed that they expect the R&D project summaries to provide 50% coverage of the qualifying expenditure included in the R&D claim, with a minimum of 3 project summaries (up to a maximum of 10).

It is not only important that the project summaries provide adequate coverage of the qualifying costs included in the claim, but also provide the specific technical details that really demonstrate the R&D definition has been met.

This is particularly important in the financial services sector, where historically, we have seen a number of enquiries focused on whether the activities included in claims meet the R&D definition i.e. activities that aim to advance technology beyond the current 'technical baseline' and where technical challenges are faced.

Given the increasing importance of technical documentation and correctly identifying R&D activities, technology teams have a key role to play in the R&D claim process however often have limited amounts of time to support the R&D claim process.

The takeaway

Banks and other financial services institutions need to ensure that their approach to R&D claims balances the need for adequate supporting documentation with efficient use of their technical team's time. In our experience, the best way to do this is to gather the necessary technical information as the R&D work is being undertaken.

We have worked with a number of companies recently to optimise their R&D claim preparation by using online tools combined with access to R&D software experts to gather the R&D information using a more 'real-time' approach. This approach minimises the time demands of the technical teams as they are able to provide the R&D details when they are undertaking the activities - plus it also ensures that documentation meets HMRC's expectations both in terms of coverage of the qualifying R&D costs and technical R&D content.

Ultimately, it's important to remember that R&D credits offer companies significant cash benefits and with the right approach, claims can be made efficiently with minimal demands on the business.

Let's talk

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Replacement of LIBOR & Reference rate reform: Tax implications for the banking sector

In brief

Regulators and industry bodies have proposed and agreed on new interest rate benchmarks to replace LIBOR (and other IBOR rates) as the latter are no longer expected to be published or supported past the end of 2021. These new risk free rates will be broad reaching across all businesses that use or invest in interest rate linked products, and affect a comprehensive set of financial instruments including fixed income securities, loans and derivatives. The impact on the banking sector is significant and transition programmes need to address operational, legal and financial, systems, client and risk management implications.

A number of Alternative Reference Rates are being developed, including SONIA (GBP), SOFR (USD) and ESTER (EUR) which all use historical transaction data.

In light of its importance and widespread use, replacement of reference rates will require great care to facilitate transition and minimise disruption, including the consideration of consequential tax impacts.

Key tax implications that will need to be considered include:

1. The tax implications of the transition itself - whether the transition itself will give rise to a tax event and if so what is the resulting tax impact?
2. Are there any potential second order impacts that will need to be considered?
3. Are there documentation or other considerations from a tax standpoint?

In detail

1. Tax implications of the transition to new reference rates

The tax treatment will depend on the nature of the tax rules in the relevant territory in relation to the instrument. A key distinction can be made between territories depending on whether tax follows accounting. Where a tax regime requires that tax follows the accounts, which is a common approach, e.g. in the UK, the tax impact will depend upon the accounting treatment of the transition. Accordingly, in such territories, any impact on the accounting results due to the transition may have a tax impact.

However, in territories where tax does not follow the accounts there may be a tax event if, for example, the modification of a contract is considered to be a disposal event that could potentially give rise to a tax event with no accounting adjustment. Some examples from specific territories are as follows:

- In Australia, financial arrangements rules are likely to result in different tax outcomes compared to accounting changes in some circumstances, e.g. the termination of existing contracts and entering of new contracts. This is due to the tax treatment following specific financial arrangements rules rather than being driven by accounting.

Replacement of LIBOR & Reference rate reform: Tax implications for the banking sector (cont'd)

- In the USA, there are potential taxable events arising on the significant modification of a taxable product. However there are circumstances where a disposal may cause unexpected tax consequences. For example a disposal being triggered less than one year into the holding of an investment may trigger higher short-term capital gains rates to apply. Other grandfathering provisions may also cease to apply if a disposal of an existing arrangement is triggered.

Where a contract is cross border there could be different tax treatment of the modification of contracts in the relevant territories that results in tax asymmetry.

2. Potential second order impacts

In addition, there may also be second order tax implications, such as:

- Hedging arrangements are likely to be widely affected. Where the transition results in hedge accounting being disturbed, this may give rise to accounting debits and credits for which there is a corresponding tax impact. For example, unintended impacts may arise where the timing of updating IBOR references by amending two separate contractual agreements is not close enough and therefore the hedging becomes ineffective.
- Transfer pricing policies and benchmarks may need to be updated where they reference IBORs, including inter-company agreements and tax authority agreements (e.g. advance pricing agreements). This includes dealing with changes required due to certain tax rules which presuppose that an IBOR linked rate must be adopted for transfer pricing purposes.
- Operational tax implications may arise, e.g. for withholding tax, transaction tax / stamp duty, tax information reporting (such as FATCA or CRS) regimes. For example, this could be as a result of modification of contracts being treated as a creation of a new instrument, or the impact of transition on availability of exemptions, grandfathering rules etc. As a specific example, withholding taxes on U.S. equity-linked derivatives which provide for a IBOR-based return to the short party may become payable due to being treated as a new issuance.
- Implications due to tax rules that require calculations to use IBOR based numbers. For example rules relating to imputation of capital, debt or interest caps (such as thin capitalisation rules), etc. As a specific example, the LIBOR cap mechanism in Australian tax law caps internal interest expense of foreign bank branches at LIBOR for the currency of the relevant borrowing.

3. Documentation and other considerations

Tax related documentation, such as transfer pricing documents, may need to be updated to reflect the transition to the new reference rate.

In addition to those outlined above, there could be other issues that require consideration from a tax perspective. Examples could include:

- Securitisation Companies. If transition results in a tax mismatch arising in a securitisation company this could result in unfunded tax liabilities. A previous example of this in the UK, was when the transition to IFRS could have resulted in unfunded tax liabilities and a special regime was introduced to address the issue.
- Special Purpose Vehicles. For example, in the US, special purpose vehicles that are not subject to entity-level taxation may not be eligible to acquire new loans, and therefore an existing contract becoming a new loan could adversely impact the entity's eligibility.

The takeaway

The tax implications of the transition to new reference rates are expected to vary significantly from territory to territory depending on the local tax rules. A key consideration is whether the tax treatment will be consistent with the accounting treatment, however there is a broad range of second order and other tax implications that will need to be considered. Due to the gradual nature of the implementation of new reference rates, we recommend that Banks take a phased approach to dealing with the tax considerations, starting with an impact risk assessment and developing a transition plan from a tax perspective.

Let's talk

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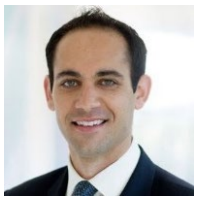

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