Tax considerations associated with LIBOR transition

The forthcoming withdrawal of LIBOR, along with other equivalent reference rates around the world, carries with it a number of potential tax consequences. Whilst the full withdrawal of LIBOR is not until December 2021, the work required to respond to the changes is not insignificant so it is important that taxpayers have plans in place to allow them to identify, assess and respond to the impact appropriately.

What is happening?

LIBOR is currently one of the primary benchmarks for short term interest rates and is used as a reference rate in a wide variety of arm's length agreements. In July 2017, the FCA announced that LIBOR would be discontinued by the end of 2021 and replaced with a new benchmark risk free interest rate. Similar projects are ongoing in most other jurisdictions.

A number of replacement interest rates are being developed, including SONIA (GBP), SOFR (USD) and ESTER (EUR). In contrast to LIBOR, which is a forward-looking term-based reference rate determined by a panel of banks, the replacement rates are risk-free rates which are backward-looking and are determined by market transactions over the reference period.

Why does this matter?

LIBOR is used as a reference rate for a wide variety of agreements, including loans and other types of financing; derivatives; leasing and hire purchase; supplier and customer arrangements, and so on. It may therefore be a **significant exercise** to identify and review all the potentially affected contractual arrangements and establish what action is needed for each, and the potential consequences. Some agreements may contain provision dealing with a change in reference rate but for others it will **be necessary to renegotiate contractual terms.**

What are the potential tax considerations?

Any change to contractual terms underlying financial instruments needs to be considered from a tax perspective. **Changes could give rise to transition of value from one party to another, or could be regarded as creating a new financial instrument**. There is also a question around whether contracts which do not allow for a transition from LIBOR will remain valid at all. Adjustments to reference rates could also have impacts on hedging arrangements and the transfer pricing position. It must also be remembered that reference rates around the world are likely to change, meaning that **for multinational enterprises, there will be considerations in a number of jurisdictions** and these must be looked at together rather than in isolation as the approach in one territory may have knock on consequences elsewhere. Some of the key tax areas that must be considered are as follows:

1 Gains or losses recognised in profit or loss

Where an amendment to the terms of an instrument gives an amount recognised in the income statement for accounting purposes, **this will generally be brought into account for tax purposes**. This could be the case where, for example, the amendment represents a substantial modification resulting in the derecognition of the old instrument and recognition of the revised instrument at fair value; or where there is a non-substantial modification which results in the recognition of the difference in expected cash flows. **Such scenarios could result in taxable gains or losses being recognised.**

2 Establish the nature of any compensation payments

To the extent that changes to contracts result in payments being made between the parties, it will be **necessary to assess the nature of the payment**. For example, where a borrower is making a payment to a lender, this will likely be treated as interest (and taxed accordingly) because it represents compensation for the use of the money advanced. In contrast, a payment from a lender to a borrower cannot be interest but the expense might be argued to be a cost incurred to ensure the continued payment of interest by the borrower.

pwc

3 Impact on hedging arrangements

A key consideration for many businesses may be whether hedging arrangements remain effective. **Changes in reference rate may result in existing hedge accounting arrangements becoming ineffective**. For tax purposes, the Disregard Regulations apply where a hedging instrument is intended to act as a hedge of a hedged item and so in some cases, tax hedging will remain effective. However, in some cases the relevant deadline to elect for the Disregard Regulations to apply may have passed, meaning it might not be possible to maintain the position.

4 Transfer pricing considerations

There are also a number of transfer pricing considerations:

- It will be important that amendments to intra-group arrangements are undertaken on arm's length terms.
- The replacement reference rates are risk free rates and will therefore differ from the existing rates. **It may not therefore be as straightforward as replacing one with the other** -it may be necessary to model the loan profile and tax consequences and assess the level of margin which would be considered to be arm's length.
- Groups should document their transfer pricing methodology to reflect the actions taken to respond to reference rate reform, in line with OECD Guidance.
- To the extent that there is a substantial modification to debt instruments, **groups may need to re-assess their thin capitalisation position.**

5 Are amendments a continuation or do they create a new agreement?

Whether the amendment of the financial instrument is regarded as a continuation of the existing instrument or the creation of a new financial instrument. **The intention of the parties will be important in this assessment**, alongside the means of reflecting the changes in legal documentation. In most circumstances, a change in terms solely to respond to the withdrawal of LIBOR is likely to be seen as a variation, with no tax consequences. However, to the extent that there are other changes made at the same time, this is unlikely to be the case and there may be tax considerations -e.g. **interest payments and WHT requirements may be crystallised.**

6 Impact on grandfathering arrangements

Some financial instruments are subject to grandfathered tax treatment (e.g. qualifying old loan relationship rules for loans entered into on or before 12 May 2016 and loans which still fall within the previous loan relationship rules which applied to loans entered into before 1 Jan 2016). **This treatment is normally subject to the instrument remaining unchanged**, so amendments to take account of reference rate reform could have an impact, although in general changes made purely to reflect reform are unlikely to lead to a withdrawal of grandfathered treatment.

7 Impact on existing Tax clearances

Where groups have agreements with tax authorities -e.g. non-statutory agreements or ATCA's, it will be necessary to assess the potential impact and whether this needs to be discussed with HMRC. **This is particularly the case where the economics of the transaction, or the tax outcomes, have changed**. Similarly, it will be important to assess the impact on existing treaty clearances or passport arrangements.

8 Potential reporting obligations

It may be necessary to consider whether changes made in response to rate reform give rise to reporting obligations under, for example, the EU Mandatory Reporting rules. Whilst HMRC have suggested that they would not expect any reporting requirements to arise, **other tax authorities may take a different view**.

What do I need to do?

The key actions for tax and treasury are as follows:

- Recognise that the issue affects many stakeholders including treasury, accounting, tax and legal. Work together to assess the impact and begin planning. It may be necessary to implement a LIBOR transition program.
- Undertake a review of all contracts which reference LIBOR or other affected reference rates. It will be important to understand what fall-back provisions exist and whether agreements need to be amended and what actions need to be taken.
- Assess the accounting and tax implications of any changes that are required, particularly where agreements are amended and hedging arrangements are impacted or transfer pricing assessments are required.
- Where new financial instruments are being entered into, ensure rate reform is considered at the outset and provisions are put in place to manage transition in order to prevent further changes being required.

Visit our dedicated LIBOR Transition for UK Corporates web page for additional information and useful resources:

https://www.pwc.co.uk/services/risk-assurance/insights/libor-transition-for-uk-corporates.html

Contacts

Please contact any of the following (or your usual PwC Tax contact)

Graham Robinson
Partner
London

M: +44 (0)7725 707297
E: graham.x.robinson@pwc.com

James Andrews
Partner
Midlands

M: +44 (0)7483 407959
E: james.andrews@pwc.com

Iain McDonald
Director
Glasgow

M: +44 (0)7483 417078
E: iain.mcdonald@pwc.com

Dan Pybus
Director
London

M: +44 (0) 7754 953461
E: daniel.j.pybus@pwc.com

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2020 PricewaterhouseCoopers LLP. All rights reserved. PwC refers to the UK member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.

2020-10-30_RITM4000415