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Tax Implications of LIBOR Discontinuation

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Speed read

After 2021, it is anticipated that London interbank offered rates (LIBORs), which are used as reference rates in the loan, bond and derivatives markets, will cease to be published. In preparation, regulators have identified recommended alternative 'nearly risk free' benchmark rates (RFRs) to replace them. Parties to financial contracts should now be thinking about the potential tax implications which may arise in the run up to, on and after LIBOR discontinuation. There is unlikely to be a 'one size fits all' result, and analysis should be undertaken on a contract by contract basis.

Although by no means exhaustive, in this article we seek to highlight some of the key UK tax considerations arising from London interbank offered rates (LIBORs) the discontinuation of and the transition to 'nearly risk free' rates (RFRs), in relation to loans, bonds and derivatives (see figure 1 for the main LIBOR rates).

Figure 1: The main LIBOR rates

Existing benchmark	Alternative RFR	Benchmark administrator
GBP LIBOR	Reformed sterling overnight index average (SONIA)	Bank of England
USD LIBOR	Secured overnight financing rate (SOFR)	Federal Reserve Bank of New York
JPY LIBOR	Tokyo overnight average rate (TONAR)	Bank of Japan

Much of the tax analysis will depend on factors such as the contractual mechanics for addressing the transition, and the applicable accounting treatment, which will vary from contract to contract.

Given that LIBORs currently underpin approximately $300trn of financial contracts, their discontinuation will have far-reaching consequences beyond the tax world. The myriad of legal, commercial and practical implications (and the reasons for the discontinuation) are beyond the scope of this article. We have, however, sought to summarise our understanding of some of the potential accounting implications where relevant to the tax treatment (with the caveat that we are not accounting experts).

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Contractual background

Existing contracts which reference LIBOR ('legacy contracts') would not switch to RFRs automatically on LIBOR discontinuation, unless the agreement expressly provides for it. Some contracts will default to 'fallback provisions' (see figure 2 for examples we have seen, addressing LIBOR discontinuation to varying degrees).

In the absence of workable fallbacks, amendment will be necessary. This will generally require all-party consent, which in some cases, may not be feasible (e.g. in the case of widely held bonds) or may be refused (e.g. if fallback provisions economically favour one party).

If fallbacks do provide for switch-over, or amendment is possible, this will not simply be a matter of replacing the relevant LIBORs with an equivalent RFR. RFRs are overnight rates, rather than term rates, and unlike LIBORs, they do not include a credit risk premium. A straight switch would therefore result in a value transfer between parties. To minimise this, an 'adjusted RFR', incorporating a spread, will be needed. Although industry bodies are attempting to reach consensus, there will not be one uniform adjustment calculation. Different approaches will likely be adopted for different classes of instrument (e.g. the methodologies for derivatives and loans are expected to differ), and parties may prefer bespoke alternatives.

These issues – the changes to the way the rate is calculated, and the manner in which the changes are brought about (e.g. under fallback provisions or as a result of amendment) – go to the crux of the legal, accounting and tax analysis.

Taxpayers subject to CGT

The primary consideration for taxpayers who are party to legacy contracts and are subject to UK capital gains taxation is whether the contractual response to LIBOR discontinuation may trigger a taxable disposal of those contracts.

If a contract's existing fallback provisions take effect, that would seem unlikely to result in a disposal; but if amendments are made to the contract, the position is more complicated.

Figure 2: Example fallback provisions addressing LIBOR discontinuation

Instrument	Sample fallback provisions
LMA senior multicurrency term facility	'The applicable LIBOR ... shall be the Reference Bank Rate... If ... no Reference Bank Rate is available ... there shall be no LIBOR for that loan and clause 17.4 (*Cost of funds*) shall apply to that loan for that interest period... 'If this clause 17.4 (*Cost of funds*) applies, the rate of interest on each Lender's share of the relevant Loan for the relevant Interest Period shall be the percentage rate per annum which is the sum of: (i) the Margin; and (ii) *the weighted average of the rates notified to the Agent by each Lender ..., to be that which expresses as a percentage rate per annum the cost to the relevant Lender of funding its participation in that Loan from whatever source it may reasonably select*.' (emphasis added) '"Reference Bank Rate" means the ... mean of the rates ... supplied to the agent at its request by the reference banks ... being .... the rate at which the relevant reference bank could fund itself in the relevant currency for the relevant period with reference to the unsecured wholesale funding market.'
Floating rate note issued in 2019	'If the company determines that LIBOR has been permanently discontinued or is no longer an acceptable benchmark for debt obligations similar to the floating rate notes, the calculation agent will use ... as a substitute ... (the "alternative rate") ... the alternative reference rate selected by a central bank, reserve bank, monetary authority or any similar institution ... that is consistent with accepted market practice ... and will, if and as directed by the company, make adjustments (the "adjustments") to the alternative rate or the spread thereon ... that are consistent with accepted market practice ... for debt obligations similar to the floating rate notes... However, if ... for any reason an alternative rate has not been determined ... the floating interest rate and the spread ... will be equal to the rate on the last interest determination date for the floating rate notes using LIBOR as the benchmark.'
Floating rate note issued in 2016	'For a LIBOR interest determination date on which ... no [LIBOR screen] rate appears ... the calculation agent will request ... each of four major reference banks ... to provide its offered quotation for deposits in the designated LIBOR currency for the period ... and LIBOR ... will be the arithmetic mean of such quotations... If the banks selected by the calculation agent are not quoting ... LIBOR with respect to that LIBOR interest determination date will be LIBOR for the immediately preceding interest reset period.'

'Disposal' is not defined in TCGA 1992, and takes its natural meaning. This creates uncertainty regarding the factors to be taken into account in assessing whether a disposal would occur. There are, however, stamp duty cases considering whether contractual amendments to a debt instrument triggered the issuance of a new instrument (e.g. Associated British Maltsters Ltd v IRC [1972] 3 All ER 192), and non-tax cases relating to the preservation of loan guarantees on an amendment to the underlying loan (e.g. Triodos Bank NV v Dobbs [2005] EWCA Civ 630), that may assist as a starting point.

Whether a disposal will be taxable will depend on what is being disposed of. For disposals of debts, for example, the answer will generally depend on whether the debt is a debt on a security within the meaning of TCGA 1992 s 251 and a qualifying corporate bond (QCB) within the meaning of TCGA 1992 s 115. Reorganisation relief may also be available if there is a 'conversion' of securities within the meaning of TCGA 1992 s 132.

Even if there is no disposal of the contract in its entirety, taxpayers will have to consider whether amendments, or any additional consideration received in respect of amendments, could be regarded as taxable part-disposals.

Interestingly, TCGA 1992 s 113A contemplates that when debts denominated in discontinued currencies switched to the euro in 1999, the 'euroconversion' would not necessarily have involved a disposal of the security (and that in the absence of disposal, there would not have been a conversion within s 132).

Taxpayers subject to the loan relationships and derivative contracts codes

CTA 2009 Parts 5 and 7 look to a company's financial statements as the starting point for computing taxable debits and credits on loan relationships and derivative contracts. Broadly speaking, ss 307, 308, 595 and 597 provide that only credits and debits recognised in the profit and loss (P&L) statement are taxed (although this includes amounts previously recognised as an item of other comprehensive income (OCI) and transferred to P&L). It is therefore essential to start the tax analysis by looking at the accounting treatment, although it may also be necessary to consider legislative overrides.

The detailed accounting impact of LIBOR discontinuation is neither the subject of this article nor something to which we are qualified to speak (and is, in any event, still subject to review by the relevant accounting standards boards). Nevertheless, IASB staff papers, published in December 2018, February 2019 and March 2019 (the 'IASB papers') have identified various accounting challenges. We have chosen to highlight a few of these to illustrate the potential impact on the tax position.

De-recognition or modification of cash products (e.g. loans or bonds)

Where contracts are amended to replace LIBORs with alternative rates, value transfers will likely occur, due to alterations in cash flows which would otherwise have arisen. As identified in the IASB papers, it is necessary to consider whether such amendments to the terms of cash products can result in either a de-recognition of the contract and the creation of a new one, or a modification of the original contract.

By way of example, and depending on the applicable accounting standards, we understand that a derecognition of an amortised cost loan could result in a P&L gain or loss based on any difference between the fair value of the 'new' loan and the book value of the 'old' loan. Alternatively, a modification of future cash flows with no de-recognition for accounting purposes could result in a P&L gain or loss by reference to the new present value of the cash flows. It is currently unclear whether any relief will be provided under accounting rules to address any such debits and credits arising in the context of LIBOR discontinuation. If not, then in the absence of targeted tax relief being introduced, these kinds of P&L debits and credits would generally be brought into account for tax purposes, subject to any other applicable exceptions or overrides.

Hedge accounting

Where relevant, taxpayers will need to consider the impact of LIBOR discontinuation on hedge accounting, and whether that could impact their tax position. For illustration purposes, we consider below the treatment of a cash flow hedge where the hedging relationship is between a LIBOR-based floating rate loan and an interest rate derivative swapping the LIBOR-based rate into a fixed interest rate. Of course, the position will vary, and consequences should be assessed on a hedge by hedge basis.

As a general rule, derivative contracts must be recognised 'on balance sheet', with fair value movements recognised in P&L. Cash flow hedge accounting reduces the potential volatility this can create. To the extent that a hedge is effective, fair value gains and losses will, broadly speaking, be kept off P&L and will instead be recognised through OCI (only impacting P&L when the hedged item is settled).

The IASB papers illustrate that LIBOR replacement may require hedge accounting for interest rate cash flow hedges to be discontinued well in advance of transition. For example, if it is no longer expected that there will be an 'economic relationship' between the loan and the swap (using the terminology of IFRS 9) or that the hedge will be 'highly effective' (using the terminology of IAS 39), potential cash flow mismatches under the hedging instrument and the hedged item could result in the prospective discontinuation of hedge accounting. (Such mismatches may arise as a result of differences in the replacement rates used in the loan and the swap, or differences in the time at which the loan and the swap will apply the replacement rates.) In certain circumstances, such discontinuation could cause the gains and losses that have been deferred to be immediately recycled to P&L. If the swap remains in place but it is not possible to adopt hedge accounting going forward, fair value movements on the swap would thereafter be recognised in P&L. Even where hedge accounting can be continued, the IASB papers explain that hedge ineffectiveness created by mismatches in rates would have to be measured and recognised in P&L.

We understand that the IASB has tentatively decided to offer some relief from the prospective discontinuation of hedge accounting in respect of a given hedging relationship for so long as there is continuing uncertainty as to the actual nature and timing of the designated future cash flows as a result of LIBOR replacement. Alas, the question of when the relevant uncertainty ends is itself likely to be uncertain.

Assessing whether any P&L debits and credits arising out of LIBOR replacement would be taxable under the general rule in CTA 2009 ss 595 and 597 is likely to be complex, and may depend on the application of the so-called 'disregard regulations' (SI 2004/3256). For interest rate cash flow hedges, where reg 9 of the disregard regulations applies, the hedge is taxed on an 'appropriate accruals basis', and fair value gains and losses would not generally be brought into account. Taxpayers relying on reg 9 should monitor, in respect of each relevant hedge, whether the conditions to the application of the regulation will continue to be met in the run up to, and following, LIBOR replacement, and in particular whether LIBOR discontinuation would impact the existence of a 'hedging relationship' within the meaning of reg 2. If reg 9 ceases to apply, debits and credits in respect of the relevant hedging relationship for the applicable accounting period would be brought into account on a 'just and reasonable basis'.

Other tax consequences

The above issues generate plenty of food for thought, but are by no means the only points which taxpayers will have to grapple with as a result of LIBOR discontinuation.

In particular, it bears remembering that, even with best efforts to minimise value transfers, post-transition cash flows under affected contracts will differ from those that would otherwise have arisen. This may trigger ongoing tax consequences and, at a minimum, will likely create some additional compliance burden. Tax rules focusing on interest income/expense will (where relevant) need to be reassessed, in light of the new interest rates. For example:

- For transfer pricing purposes, taxpayers will need to consider whether replacement interest rates for related party contracts constitute an arm's length rate.
- Taxpayers should consider how the replacement rate compares against market rates. Might the new rate exceed a reasonable commercial return for the purposes of the income distribution rules, the

stamp duty loan capital exemption and 'equity holder' status?

— Corporate interest restriction calculations will likely need to be revised.

Next steps

Whether HMRC will offer guidance clarifying the tax consequences of LIBOR discontinuation and/or targeted relief from issues arising remains to be seen. Nevertheless, although 2021 may seem far off, taxpayers should begin preparing now.

In particular, for legacy contracts, taxpayers should, as soon as possible, take steps to identify how those contracts will change (if at all); and, where relevant, what the accounting implications will be.

In addition, particular action will be required from taxpayers affected by the possibility of accelerated P&L recognition if hedge accounting must be discontinued before LIBORs are actually replaced. It will be especially important for relevant taxpayers to actively monitor proposals for accounting relief from accounting standards boards and (where applicable) the continued availability of tax relief under the disregard regulations.

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