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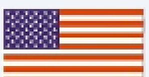
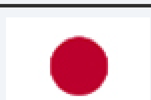
TAX IMPLICATIONS OF BENCHMARK REFORM: UK TAX AUTHORITY WEIGHS IN

To Our Clients and Friends:

It is expected that, from the end of 2021, London Interbank Offered Rates ("LIBORs"), which are used as reference rates in the loan, bond and derivatives markets, will cease to be published. Instead, these rates will be replaced with alternative 'nearly risk free' rates ("RFRs"). A different RFR will be available for each currency in which LIBOR is offered (as to which, see the table below). Similar reforms of other benchmarks (e.g. EONIA) are also being undertaken.

	Existing benchmark	**Alternative RFR**
	GBP LIBOR	Reformed Sterling Overnight Index Average (SONIA)
	USD LIBOR	Secured Overnight Financing Rate (SOFR)
	JPY LIBOR	Tokyo Overnight Average Rate (TONAR)
	CHF LIBOR	Swiss Average Rate Overnight (SARON)
	EUR LIBOR	Euro Short-Term Rate (€STER)

Contracts referencing LIBORs with a term beyond 2021 (so-called 'legacy' contracts) will therefore need to be amended, to transition to RFRs. This transition may have tax implications. On 19 March 2020, the UK tax authority, HM Revenue & Customs ("HMRC"), published draft guidance setting out its views on certain of the potential UK tax issues arising as a result of transition. Simultaneously, it launched a consultation inviting taxpayers to comment on the draft guidance, and identify any other tax issues arising from benchmark reform.

Overall, HMRC has taken a sensible approach, and its draft guidance will give some comfort to affected taxpayers. However, there is some remaining uncertainty due to omissions from the draft guidance, the subjective judgement required by certain aspects of the draft guidance, and the likely timing of final guidance. In addition, certain tax issues arising from benchmark reform may call for legislative responses (if HMRC is inclined to offer relief). Comments are now invited by 28 August 2020 (following a deferral from the original 28 May 2020 deadline).

Background

This transition to RFRs will not be implemented through legislation, and will instead be market-led. This means that taxpayers that are party to legacy contracts will need to amend them. Practically speaking:

- Interest provisions may be amended directly; or
- Existing "fallback provisions", which contemplate a method for calculating interest if LIBOR is temporarily unavailable, may be amended to provide for the transition to RFRs on (or before) LIBOR's permanent cessation.

For derivatives, ISDA favours the latter approach, and will be publishing a "protocol" to the ISDA Master Agreement which parties can choose to apply to their legacy contracts. For loan agreements, the LMA has published draft provisions, although amendments would need to be agreed between all parties. (For some syndicated loans, majority lender consent may be sufficient.) For bonds, the process is, as a practical matter, likely to be more complicated, as typically, the consent of between 90% and 100% of noteholders must be obtained via a consent-solicitation process.

Amendments will not simply involve replacing references to LIBOR with the applicable RFR. This is because RFRs differ from LIBORs in two key ways: they are overnight, rather than term rates, and they do not contain a credit-spread. Therefore, in addition to replacing the relevant LIBOR, adjustments will be needed to minimise changes to the existing economics:

- RFRs will need to be compounded over the relevant interest period; and
- To prevent value-transfer, it will be necessary to either (i) add an adjustment-spread to the interest rate or (ii) make a one-off equalisation payment (a "one-off payment"), to compensate for the lower future return.

Over the past year, in sterling bond, loan and derivatives markets, a consensus generally seems to have formed regarding preferences for these proposed adjustments. The table below provides a broad overview, based on responses to consultations from regulatory and trade bodies, and (limited) reported transactions:

	Term	**Spread**
Bond	RFR compounded in arrears (over "observation period" 5	Forward spreads between LIBOR and RFR

	business days ahead of interest period)	
Derivatives	RFR compounded in arrears (over "observation period" 2 business days ahead of interest period)	Mean spread between LIBOR and RFR over 5 year look-back period
Loan	RFR compounded in arrears (No consensus on observation period)	Mean spread between LIBOR and RFR over 5 year look-back period

Two points, which may impact the tax consequences of benchmark reform, are worth noting:

- As between different kinds of instrument (e.g. derivatives, loans etc.), there is divergence on technical aspects of the proposed adjustment calculations. The sterling-market approach may also differ from that taken with other currencies.

- Spread-adjustments based on historical spreads between LIBORs and RFRs (which is seemingly the favoured approach) will result in some value-transfer between counterparties.

<u>The consultation and draft guidance</u>

Following engagement with stakeholders, HMRC has launched a consultation and issued draft guidance regarding the potential UK tax implications of benchmark reform.

The consultation identifies statutory references to LIBOR (such as lease discounting provisions), and asks for views on an appropriate replacement. More substantively, however, it calls for (a) the identification of wider UK tax issues arising from benchmark reform, and (b) views on HMRC's draft guidance (which addresses many of the potential problems HMRC is already aware of).

On the whole, HMRC has taken a pragmatic and sensible approach in the draft guidance. Nevertheless, (a) their position on certain issues may cause difficulties and (b) there are some points on which they have remained silent.

Tax consequences arising from accounting implications

Amendments to legacy contracts may result in debits and credits being recognised in taxpayers' profit and loss statement ("P&L"). Generally, amendments may impact (a) the measurement and recognition of financial instruments and (b) (where relevant) hedge accounting. Accounting standards bodies propose to offer some relief, to minimise the accounting implications of benchmark reform. However, they have stopped short of offering full relief. A (non-accountant's) high-level overview of possible accounting impacts, and proposed IASB reliefs (published on 9 April) is set out below:

	Possible accounting implication	Proposed IASB relief for changes required by benchmark reform
Measurement and recognition	Fair value: Value transfer recognised via change in fair value	No relief proposed
	Amortised cost: · Possible derecognition if “significant modification”; · Otherwise, carrying amount recalculated, with gain / loss immediately recognised in P&L	Broadly (subject to certain conditions): · No derecognition; · No immediate change in carrying value / gain or loss recognised in P&L. Instead, effective interest rate updated
Hedge accounting	· Discontinuation; or · Increased hedge-ineffectiveness	· Broadly (subject to certain conditions), no discontinuation; · No relief for increased hedge ineffectiveness

Generally, amounts recognised in a taxpayer’s P&L would be brought into account for UK tax purposes pursuant to the loan relationship rules and / or the derivative contracts rules (at Parts 5 and 7 of the Corporation Tax Act 2009), as applicable. HMRC’s draft guidance suggests that there will be no tax relief for these accounting debits and credits.

Broadly, potential tax volatility arising from fair value accounting of hedging instruments is managed in one of two ways: hedge accounting, or the ‘disregard regulations’ (SI 2004/3256). In very high-level terms:

- Where hedge accounting is applied, to the extent that a hedge is effective, fair value gains and losses will generally be kept off P&L (and hence not taxed) until settlement of the hedge.
- The disregard regulations (which taxpayers must elect into) allow the hedge to be taxed on an ‘appropriate accruals basis’, so that fair value gains and losses would not generally be brought into account for tax purposes.

For taxpayers who have taken the latter approach, the draft guidance confirms that (notwithstanding amendments to give effect to benchmark reform), the disregard regulations will continue to apply, provided an intention to hedge remains. However, for taxpayers relying on hedge accounting, benchmark reform may have a greater impact (as to which, see further below).

Tax consequences arising from fact of amendment

One key tax concern is that amendments giving effect to benchmark reform could be considered sufficiently material to give rise to a new instrument. If so:

- Grandfathering relied upon could fall away;
- Tax clearances obtained might need to be refreshed;
- A stamp duty reserve tax ("SDRT") charge could apply for instruments in clearing or depositary receipt systems; and
- Reporting obligations could be triggered e.g. under DAC6 (the new EU reporting regime for certain cross border arrangements).

The draft guidance confirms that amendments stemming from transition would "normally be viewed as a variation" rather than the creation of a new instrument". However, this is dependent on "*the economics of the transaction [remaining] mostly the same*" (emphasis added). Continued reliance on clearances is subject to stricter conditions, e.g. that amendments "not [affect] the economics of the transaction".

Tax consequences arising from difference in interest rate

Spread-adjustments

Many UK tax provisions require a contract's terms to be compared against market-standards. For example, taxpayers may need to consider whether:

- The terms are arm's length for transfer pricing purposes;
- The interest rate is more than a reasonable commercial return, to assess whether:
    a. interest payments may be treated as distributions;
    b. a loan is a "normal commercial loan" (e.g. to test whether lenders may be "equity-holders" for the purposes of applying group relief provisions and/or whether it is a qualifying corporate bond ("QCB") for capital gains tax ("CGT") purposes); and
    c. the stamp duty/SDRT loan capital exemption may apply.

A question arises as to whether, for these purposes, amended terms must be re-tested by reference to prevailing rates at the time of amendment. Given the commercial desire to broadly preserve existing economics, and the time which may have elapsed since the contract was entered into, if this *was* necessary, these tests may well be failed. Helpfully, the draft guidance generally considers that these provisions can continue to be applied by reference to the position when the contract was originally entered into (although the "normal commercial loan" test is not expressly referred to). However, as this outcome is dependent on amendments being treated as mere variations to existing contracts, the tax treatment again hinges (indirectly) on the economic impact of the amendments.

One-off payments

The draft guidance provides some helpful confirmations regarding the UK tax treatment of one-off payments:

- Such payments will generally be taxable/deductible for corporation tax purposes (as applicable), provided corresponding debits and credits are recognised in P&L; and
- For withholding tax purposes:
    - payment by borrowers under loans will be treated as interest; but
    - payments by lenders or under derivatives will not attract withholding (because, respectively, they will not constitute annual payments, or the withholding tax exemption for derivative contracts will apply).

<u>Some key potential issues</u>

Economic qualifiers

The helpful position which HMRC has generally taken in the draft guidance is, in some instances, qualified by reference to the economic impact of amendments – with the level of value-transfer which is tolerable seeming to vary depending on context. For example, continued reliance on existing clearances requires "no change in economics", whereas for amendments to qualify as variations, the economics must remain "mostly the same".

Benchmark reform constitutes an exceptional event. The need for amendment is not being driven by voluntary commercial forces, but rather by regulatory will, and market-standards (which seem to be moving to a position where some level of value-transfer is unavoidable) may leave taxpayers with little choice regarding the extent to which the economics are ultimately altered. If the above qualifications are ultimately retained, the tax impact of amendments required by benchmark reform will depend on subjective judgments. This introduces uncertainty, which risks impeding the wider transition process. In contrast, when assessing whether grandfathering is preserved for example, HMRC proposes to look at the *purpose* of the amendment - "HMRC would normally expect [grandfathering] to continue where amendments are made for the purpose of responding to benchmark reform". The potential tax implications of amendment would be significantly simplified if, across the board, this was the sole criterion applied by HMRC.

Form-over-substance

In a departure from recent themes, the draft guidance indicates that HMRC may, in this context, take a form-over-substance approach, with tax treatment dependent on the manner in which amendments are executed. It notes that "the intention of the parties, and how this is reflected in the legal documents, will be significant factors in determining whether the changes constitute an amendment to an existing financial instrument, or as the redemption and replacement of an existing financial instrument with a new financial instrument". Where, for example, a legacy trade referencing LIBOR is rebooked on the same terms (except to the extent necessary to give effect to benchmark reform), questions may arise as to whether HMRC would characterise that as an "amendment".

If continuity of tax treatment is dependent on a particular amendment process being followed, this risks creating an additional burden for taxpayers. This is particularly true for financial institutions, who will be faced with huge volumes of contracts requiring amendment – but without the benefit of operational flexibility. Again, an approach which looks to the purpose of amendment, rather than the manner in which it is effected, would significantly lighten the potential burdens created by benchmark reform.

CGT not addressed

The draft guidance is silent on whether amendments may trigger disposals (or part-disposals) for CGT purposes. It is directed towards businesses, and addresses both the corporation tax position (discussed above) and income tax position (noting that "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.") However, legacy contracts may (a) constitute capital asset/liabilities for businesses, and/or (b) be held by individuals (e.g. floating-rate bonds issued into retail-markets).

If a contract is a QCB, a disposal would, in any event, be exempt from CGT. However, clarity as to whether amendments to non-QCBs and other capital instruments would trigger a disposal would be helpful. This is not only relevant to taxpayers subject to CGT. Regulators are encouraging financial institutions to begin discussing amendments with counterparties, and issuers of floating-rate notes may be considering consent-solicitation processes to amend such notes. If (where relevant) financial institutions/issuers are unable to provide clarity regarding the CGT implications of amendment, there is a risk that these processes may be impeded.

Timing

HMRC had originally called for comments on the draft guidance, and responses to the consultation, by 28 May. As a result of the COVID-19 pandemic, this has been delayed until 28 August 2020. HMRC are also considering constituting a working-group. Engagement with stakeholders is certainly welcome, and typically, enhanced opportunity for taxpayers to respond to a consultation is a positive outcome. However, both points raise timing concerns. Notwithstanding the ultimate deadline of year-end 2021 for the discontinuation of LIBOR, timing is of the essence. It is the aim of the Sterling Working Group on RFRs that the 'stock of LIBOR-referencing contracts [should be] reduced significantly' by the end of Q1 2021, and there is substantial (and growing) regulator pressure for market participants to transition to RFRs. On 22 April, Bloomberg (which has been chosen by ISDA as the "adjustment services vendor" to calculate and publish benchmark reform adjustments for legacy over the counter derivatives) substantially progressed the path to amendment by publishing a "rulebook", setting out proposed amendment terms. These factors mean that amendment processes are likely to begin in earnest in the coming weeks and months. In the absence of final guidance from HMRC in the near future, there is a real risk that, due to these wider forces, taxpayers may end up having to amend legacy contracts without certainty regarding HMRC's position on the tax implications of doing so. Given that taxpayers have neither chosen, nor can avoid, benchmark reform, this would be regrettable.

Potential accounting issues

The draft guidance notes that "projects are ongoing to decide if amendments to International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Practice (UK GAAP) are needed to address accounting issues that arise because of the restructuring of contracts as a consequence of benchmark reform".

Based on current IASB proposals, for instruments accounted for on fair value basis, any value transfer on transition is likely to result in some debits and credits being recognised in P&L. Where there is an increase in value and credits are recognised, (based on the current UK guidance) it is expected that such credits would be taxable. However, where there is a decrease in value and the recognition of debits results in an overall loss for the period, the UK tax position may be complicated by quantitative restrictions on the use of carry-forward losses. If losses realised in the period in which the transition takes place were carried forward, then (subject to a £5 million annual allowance) corporates could only offset them against 50% of profits in any subsequent year. For banks, the figure is limited to 25% of profits.

Moreover, the lack of (complete) alignment between adjustments to categories of financial instruments may be a cause of concern for taxpayers that are party to hedges and apply hedge accounting. Any differences in amendments made to hedging, and hedged, instruments may result in increased hedge ineffectiveness going forward. It appears (based on current proposals) that the IASB does not intend to offer relief to address this - with the result that, going forward, changes in market value would, to the extent of such ineffectiveness, be recognised in P&L and taxed. As above, this may be more than a mere timing point; if the impact cannot be off-set over the instrument's term due to restrictions on loss carry-forwards, there may be a real tax cost. Moreover, (in the absence of a concession from HMRC) it would not be possible to circumvent the tax impact of increased hedge ineffectiveness by electing into the disregard regulations, as elections cannot be made in respect of existing agreements.

If the proposed scope of IASB relief is not expanded to address the above accounting impacts, it remains to be seen whether HMRC would be willing to step in. The above issues are not addressed in the draft guidance. However, that is largely unsurprising. If HMRC considered it appropriate to offer relief addressing the above issues, a legislative fix would likely be required.

Conclusion

The draft guidance is largely helpful and will go some way in providing comfort to UK taxpayers impacted by benchmark reform. However, it does not offer a complete solution.

Based on the current draft:

a. To minimise the tax implications of transition, UK taxpayers would need to (i) curtail value-transfers, and (ii) (where relevant) align amendments to hedging, and hedged, instruments. However, depending on where market-standards crystallise and whether different counterparties are involved, practically-speaking, both matters may be outside a taxpayer's control.

b. Taxpayers face uncertainty due to (i) omissions from the draft guidance, (ii) the subjective-judgment inherent in certain aspects of the draft guidance and (iii) the likely timing of final guidance.

These factors risk putting taxpayers' understandable desire for tax-neutrality and certainty at odds with both commercial drivers, and regulatory time-tables.

Moreover, if the scope of IASB relief remains as currently proposed, there may be circumstances where taxpayers may wish to call for legislative action to limit the tax impact of transition.

This client alert is based on an article by certain of the authors published in Tax Journal on 21 April 2020.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the Tax Practice Group or the authors:

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