ISDA® Safe, Efficient Markets

UK FINANCE

Her Majesty's Revenue & Customs
c/o Oli Jones
By email

Date: 8 June 2020

Dear Oli,

HMRC Consultation Document on the taxation impacts arising from the withdrawal of LIBOR

UK Finance is the collective voice for the banking and finance industry operating in and from the United Kingdom. Representing more than 250 domestic and international firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation. Our members include businesses that are large and small, national and regional, corporate and mutual, retail and wholesale.

The International Swaps and Derivatives Association ("ISDA") is a trade organisation, which represents over 850 member institutions from 67 countries, with a broad range of derivative market participants including "buy-side" or end user participants from different economic sectors, including corporations, investment managers, pension funds and insurance companies, as well as international and UK financial institutions.

UK Finance and ISDA welcome the publication, on 19 March 2020, of a consultation document on "the taxation impacts arising from the withdrawal of LIBOR", together with HMRC's draft guidance on the subject. As noted in our previous correspondence with HMRC, the potential tax implications of benchmark reform constitute a material (and increasingly pressing) issue for our members, and we thank HMRC for its engagement with us (and previously, AFME) on this issue over the course of the last year.

The consultation document and guidance are helpful vehicles for raising the profile of benchmark reform, and importantly, for providing greater certainty to taxpayers on the tax implications of transition.

Nevertheless, we consider that certain omissions from, and certain aspects of, the draft guidance may create uncertainty in the markets regarding the tax implications of transition. As HMRC is no doubt aware, regulators have consistently emphasised the importance of a smooth and timely transition to alternative risk free rates ("RFRs"). Such uncertainty may serve as a barrier to securing the consent needed from parties to legacy contracts to make amendments to implement benchmark reform, and accordingly, risks impeding the broader transition project. We consider that certain amendments to the draft guidance would be needed to give market participants (including financial institutions and their counterparties) certainty of tax treatment before large portfolios are transitioned.

These issues are addressed in more detail in our joint response (set out in Annex 1 to this letter) to certain of the questions posed by the consultation document. In case helpful, we have also prepared (at Annex 2 to this letter) a mark-up of the draft guidance, reflecting certain points raises in our responses.

We look forward to continuing our engagement with HMRC on this issue.

Yours sincerely,

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Annex 1
Response to certain questions posed by consultation document

1. Introduction

Q1 Are there any additional issues that should be included in the draft guidance, or points that could be expressed more clearly?

A. Concerns arising from draft guidance

(i) Form of the amendments

1. We welcome HMRC's confirmation that "Where the parties agree to change the terms of the instrument for the purposes of responding to the withdrawal of LIBOR, HMRC would normally view this as a variation of the existing instrument.".

2. One point of concern arises, however, in respect of the statement 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."

3. For many of our members, the contracts to which they are party are recorded on internal systems. Subject to limited exceptions, contracts are not effected on these systems, and the underlying transactions recorded thereon are given legal effect via separate (written or verbal) agreements. As an operational matter, many of our members are likely to record amendments to legacy contracts by cancelling an existing systems booking and re-booking a 'new' transaction in the systems with a new transaction date but generally the same parameters as the legacy transaction (except as to the applicable benchmark rate, etc.). This is because if the changes were instead booked as amendments to existing bookings, the system may recalculate historical cash flows to reflect the change (even though the amendments would only take effect going forward). The "re-booking" approach is therefore simply a practical operational response to a systems limitation which creates an administrative problem. It should not be inferred from the mere fact of re-booking that the intention of the parties is to create a new contractual relationship.

4. We are concerned that, notwithstanding the parties' intentions, the guidance (as currently drafted) may create doubt as to whether HMRC consider that this approach would result in the creation of a new contract for tax purposes. This may require taxpayers to weight the benefit of continuity of tax treatment against the burden of significant operational hurdles, and choose between the two. Such uncertainty, and the possibility of such choices having to be made, is likely to impede the amendment process, and may put the timetable targeted by regulators at risk (as to which, see further below).

5. Operational flexibility in implementing benchmark reform is hugely important to our members, who in aggregate, make up a huge portion of the population of UK taxpayers impacted by benchmark reforms. We would therefore ask that the guidance include express confirmation that the manner in which amendments are booked in systems such as those referred to above will not be a relevant factor in determining whether amendments are treated as variations to existing contracts, or as giving rise to new contracts. We have included language to this effect in our mark-up of the draft guidance.

(ii) Economic qualifiers

6. Subject to the issues mentioned in paragraphs 1 to 5 above, we welcome the helpful statements in the draft guidance on the subject of whether amendments could:

- give rise to a new contract; or
- otherwise cause assessments, which are made at the time of entry into a contract, to be revisited (e.g. in the context of determining whether the terms of the contract are on arm's length for transfer pricing purposes, or whether the interest rate constitutes more than a reasonable commercial return for distribution purposes and in applying the loan capital exemption).

7. Nevertheless, we are concerned by the fact that, in a number of contexts, the draft guidance contemplates that the tax consequences of amendments will depend on their economic impact. In some instances, this is an express condition. For example, for amendments to qualify as variations, the economics must remain "mostly the same", while continued reliance on existing clearances is dependent on there being "no change in economics" (a particularly difficult condition to meet). In other contexts, the economics of the amendments constitute an *indirect* condition to the retention of existing tax treatment. For example, in the context of grandfathering, and in determining whether taxpayers need to reassess whether the (revised) interest rate constitutes more than a reasonable commercial return (in the context of distribution treatment and in applying the loan capital exemption), the draft guidance indicates that HMRC will look to the *purpose* of the amendments. However, in each of these cases, tax neutrality would be dependent on the amendment constituting a mere variation of an existing contract (rather than a new contract). Accordingly the tax treatment again hinges (indirectly) on the economic impact of the amendments, which would need to "remain mostly the same".

8. In particular, we would note that market-standards appear to be moving to a position where some level of value-transfer is unavoidable. For example, consultations in the derivatives[1] and sterling loan[2] markets indicate that participants favour a spread adjustment based on the mean historical difference between the relevant LIBOR and the relevant alternative risk free rate ("RFR") over a five year look back period (see further paragraph 41 below). As this is a backwards looking test, it will not replicate the parties expectations as to differences between LIBOR and the RFR going forward (had LIBOR been retained), and will result in some value transfer. As ISDA CEO Scott O'Malia has noted, "the [term and spread] adjustments [to RFRs] are intended to ensure the contracts function as closely as possible to what the counterparties originally intended….That doesn't mean the adjusted RFR will exactly match the relevant IBOR – it won't, so there will be winners and losers."[3]

9. Parties may generally wish to (or may come under pressure to) follow market standards. In practice therefore, the extent to which the economics may remain "mostly the same", and the ability to benefit from continuity of tax treatment, may not be matters within taxpayers' control.

10. We of course recognise that, as a general matter, it may be appropriate for tax treatment to depend on economics. However, we would stress that the above-mentioned provisions are not concerned with the general question of whether value transfers should be taxed. (For most taxpayers, that would depend on the applicable accounting treatment and whether HMRC considered it appropriate to offer any additional relief). Rather, these are incidental questions relating to continuity of tax treatment. Moreover, we would note that the rules in question generally do not accommodate a progressive approach to tax treatment. Rather, the outcome is generally binary, and subject to a (indeterminable) cliff edge (e.g. either the economics remain mostly the same and existing tax treatment can be preserved, or the economics do not, and the existing tax treatment falls away). As a result, taxpayers face significant uncertainty in a context capable of producing materially different outcomes.

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[1] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/summary-of-responses-on-consultation-credit-adjustment.pdf?la=en&hash=87721B80E18C02FD605C4B40F31ED10709F425A5
[2] http://assets.isda.org/media/3e16cdd2/d1b3283f-pdf/
[3] https://www.isda.org/2019/05/29/another-step-to-benchmark-fallbacks/

11. For these purposes, we would therefore ask HMRC to consider an approach which looks *solely* to the purpose of the amendments - with the only condition to continuity of existing tax treatment being that amendments are made solely for the purposes of benchmark reform.

12. We are conscious that HMRC may have concerns about adopting an approach which ignores economic factors, lest rogue taxpayers seek to use the veil of benchmark reform as an opportunity to disguise other value transfers. In this respect, we would highlight HMRC's statement that the guidance only applies to the extent that taxpayers lack a tax avoidance motive. Moreover, even in the absence of a tax avoidance motive, HMRC would be able to consider amendments unconnected to benchmark reform separately. For example, if the purpose of amendments to legacy contracts was not *solely* to give effect to benchmark reform, then:
    a. *To the extent* that changes in economics arose from amendments which *were* for the purposes of benchmark reform, the related economic impact would be ignored in testing whether the amendment was sufficiently material to constitute a variation, or the revised interest rate constituted more than a reasonable commercial return; and
    b. Only the changes which were made for unconnected purposes would be considered in assessing whether those changes were sufficient to give rise to a new contract, or required the above tests to be revisited.

    We note, for example, that a similar approach has been taken by the IASB in the context of accounting reliefs[4]. This would have the effect of treating the two sets of amendments as though they were made separately, and would ensure that taxpayers would not be put at a disadvantage where, as a matter of convenience, amendments for the purposes of implementing benchmark reforms were made at the same time as unconnected amendments. We consider that this should allay concerns that HMRC may have about the scope of the guidance, or the possibility of it being used in unintended ways.

Timing concerns

13. We are thankful for HMRC's engagement with stakeholders (ourselves included) on the issue of benchmark reform, including your participation in a call on 1 May regarding potential timing issues arising out of the deferral of the consultation deadline to August 2020.

14. As discussed on the call, regulators have consistently emphasised the importance of a smooth and timely transition to RFRs. Indeed, regulators have recently confirmed that the COVID-19 pandemic will not alter the overall timetable to transition (although certain milestones may need to be adjusted). 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 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.

15. We are therefore hugely grateful for the assistance offered by HMRC in seeking to mitigate the impact of the deferral to the consultation deadline by:
    a. agreeing to discuss the timeline for final guidance, and the above mentioned timing issues with other regulators / governmental organisations e.g. the FCA, thereby assisting in the effort to ensure that taxpayers will not be penalised or otherwise prejudiced by waiting

[4] As to which, see the proposed amendments to accounting standards at paragraph 6.9.6 of the Exposure Draft published on 9 April (https://cdn.ifrs.org/-/media/project/ibor-phase-2/ibor2ed2020.pdf)

until final guidance has been published by HMRC before commencing amendment discussions with counterparties;

b. considering consultation responses submitted prior to the deadline, and in particular, confirming HMRC's willingness to publish interim updates to the draft guidance should its position regarding the contents of the current draft guidance change;

c. agreeing to participate in a call with UK Finance and ISDA to discuss this consultation response.

16. Given the importance of this issue to our members, to address circumstances where it is not possible for taxpayers to wait until the publication of final (or even updated) guidance before amending legacy contracts, we would additionally ask HMRC to consider whether it may be willing to provide some comfort that the final guidance would not put taxpayers in a worse position than the current draft. By way of comparison, we note that in the US, the IRS confirmed that, pending the finalisation of regulations addressing benchmark reform, taxpayers would be able to rely on the draft regulations[5]. We appreciate that the context here is slightly different, as HMRC's response is likely to take the form of guidance clarifying its interpretation of existing laws. Nevertheless, any steps which HMRC could take to provide certainty to the above-mentioned taxpayers would be extremely welcome.

17. Lastly, if / where HMRC considers it necessary to give effect to its intentions via legislative means, we would ask that such legislation be applied retrospectively to 1 January 2020. This would ensure that taxpayers who, in response to above timing pressures, have amended their legacy contracts prior to its introduction would not be prejudiced.

B. Additional issues

(i) *Additional payments*

18. We thank HMRC for including confirmation in the draft guidance regarding the tax treatment of additional payments made in respect of amendments to legacy loans and derivatives. We note, however, that additional payments may also be made in respect of other types of legacy transactions (e.g. leases referencing LIBOR). It would be helpful to include confirmation in the draft guidance as to how HMRC considers such payments should be treated. Taking leases as an example, we consider that it would be most natural to treat such payments as increased rental payments or rental rebates depending on whether the payment is from lessee to lessor or vice versa. We have reflected this view in our comments on the draft guidance. Nevertheless, our primary concern is that HMRC's position on how such payments should be treated (whatever that may be) is set out in the guidance.

19. Similarly, we should be grateful if the guidance could confirm the characterisation of additional payments for VAT purposes. We consider that if an additional payment is made (in whichever direction) under a loan relationship or a derivative contract, such payment should be consideration for an exempt supply for VAT purposes. In the context of other types of legacy transaction, in our view the additional payment should be treated as an adjustment to the consideration for the original underlying supply. For example, to our mind, the VAT treatment of additional payments under a legacy lease should follow the treatment of rental payments / rental rebates under or in respect of the lease (themselves dependent on whether the relevant property is opted to tax). Again, we have reflected this in our comments on the draft guidance.

20. The guidance confirms that additional payments made by a borrower would generally be treated as interest for income / corporation tax purposes. This raises two related points. We would welcome confirmation:

[5] https://www.federalregister.gov/documents/2019/10/09/2019-22042/guidance-on-the-transition-from-interbank-offered-rates-to-other-reference-rates

a. as to whether HMRC considers that such payments would constitute interest for all tax purposes, including in the context of reporting obligations, such as:
   1. obligations under the Data-gathering Power (Relevant Data) Regulations 2012 (S.I. 2012/847) and / or schedule 23 to Finance Act 2011; and / or
   2. Automatic Exchange of Information obligations arising under the International Tax Compliance Regulations 2015 (S.I. 2015/878) (as amended); and
b. that any clearances obtained in respect of interest payments under the relevant instrument (e.g. treaty clearances) would equally apply to such additional payments without need for further action.

21. Finally, we would ask that the guidance address the tax treatment of one-off additional payments in the hands of taxpayers other than businesses holding instruments for the purposes of a trade or property business (e.g. individuals), including:
    a. confirmation as to whether such payments would be income or capital in the hands of the recipient;
    b. if capital, confirmation as to whether HMRC considers that such payment should be treated as a part-disposal; and
    c. if income, confirmation as to whether HMRC intends to offer any relief to taxpayers who (but for transition) would have benefitted from the annual personal savings allowance in respect of receipts under the unamended legacy interest (e.g. LIBOR-based interest payments).

(ii) *"Normal commercial loan" status*

22. There are a number of contexts in which it is necessary to test the terms of a contract against market standards at the time it was entered into. As noted in the guidance, the question may arise as to whether, following the amendment of legacy contracts, it is necessary to revisit these tests. We welcome the inclusion of guidance on this point in the context of transfer pricing, the application of the loan capital exemption (at section 79 FA 1986), and the distribution rules (at Chapter 23 CTA 2009). We note, however, that a similar point arises in assessing whether a loan is a "normal commercial loan" within the meaning of section 162 CTA 2010 (in the context of provisions governing "equity holder" status in Chapter 6 of Part 5 CTA 2010). This test is also relevant to the determination of whether an instrument is a QCB within the meaning of section 117 TCGA 1992. Given its wide relevance, it would be helpful for the draft guidance to include confirmation that, as in the above contexts, HMRC generally considers that this test can continue to be judged by reference to the position at the time the legacy contract was originally entered into. This point is addressed in our comments on the draft guidance.

(iii) *Election into the Disregard Regulations*

23. We welcome HMRC's confirmation in the draft guidance that, for taxpayers who have already opted into the regime, the Disregard Regulations (S.I. 2004/3256) will continue to apply, provided that an intention to hedge remains.

24. Hedging instruments are generally accounted for using "mark to market" (i.e. fair value) accounting. To smooth tax volatility in respect thereof, taxpayers typically rely on either the Disregard Regulations, or hedge accounting. As explained in answer to question 13 below, for taxpayers applying hedge accounting, any lack of alignment between amendments to hedged instruments and hedging instruments in giving effect to benchmark reforms may result in increased hedge ineffectiveness going forward. This would mean that (to the extent of the ineffectiveness), changes in market value would be brought into account into the profit and loss statement, and taxed under Parts 5 or 7 CTA 2009 (as applicable).

25. Such taxpayers would not historically have needed recourse to the Disregard Regulations to smooth volatility. Following amendment, however, certain of these taxpayers may potentially

wish to avail of the regime. Due to the strict conditions for election into the Disregard Regulations (at Regulations 6A) this alternative would not be open to them. We would therefore ask HMRC to consider relaxing these strict conditions for legacy contracts. Specifically, we would ask that HMRC consider:

a. By way of concession from the requirement that taxpayers wishing to elect into the Disregard Regulations must do so for *all* their derivative contracts, allowing taxpayers who wish to avail of the regime to elect into the Disregard Regulations in respect of legacy contracts only (with such choice capable of being made on a legacy-contract by legacy-contract basis); and

b. By way of concession from the requirement that an election into the Disregard Regulations must precede entry into the relevant contract, enabling such election to be made, on a going-forward basis only, in the six months following amendment.

(iv) Anti-Hybrid mismatch rules

26. There may be differences in the manner in which amendments to legacy contracts to give effect to benchmark reform are treated in the UK, as against other jurisdictions. For example, a UK taxpayer may treat such amendments as a variation to a legacy contract, whereas its non-UK counterparty or others subject to tax in respect of the contract may be required to treat the amendment as giving rise to a disposal of the legacy contract and the creation of a new contract. This could result in mismatches that may be relevant to the treatment of the legacy contract for the purposes of the anti-hybrid mismatch rules at Part 6A TIOPA 2010.

27. We would be grateful if HMRC would consider amendments to the 'permitted time period' rules in section 259HB to accommodate timing differences (resulting from differences in the tax treatment of amendments across jurisdictions) and prevent taxpayers having to submit claims for an extended permitted time period in relation to such mismatches.

(v) Capital gains tax treatment

28. We note that the draft guidance is silent on whether amendments may trigger disposals (or part-disposals) for capital gains tax ("CGT") purposes. We appreciate that the draft guidance is directed towards businesses, and addresses the tax treatment which would apply where a contract is entered into for the purposes of a trade or property business. However, we would stress that legacy contracts may (a) constitute capital assets/liabilities for businesses, and/or (b) be held by individuals (e.g. floating-rate bonds issued into retail-markets).

29. We acknowledge that if a legacy contract was a qualifying corporate bond ("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 extremely helpful.

30. In this respect, we would stress that this question is not only of relevance to taxpayers subject to CGT, but also to their counterparties. In particular, our members are being strongly encouraged by regulators to begin discussing amendments to legacy contracts with other parties to the agreements. Moreover, corporate issuers of floating-rate notes may be considering consent-solicitation processes to amend such notes – a process which typically involves the consent of between 90% and 100% of noteholders. Where counterparties / noteholders are taxpayers subject to CGT, there is a material risk that these processes will be impeded if financial institutions/issuers are unable to provide clarity regarding the CGT implications of amendment.

31. As indicated in our letter to HMRC of 15 November 2019, we consider that, for CGT purposes amendments to legacy contracts should not generally constitute disposals (or part disposals).

We acknowledge, however, that if a capital gains taxpayer received a separate inducement payment for agreeing to amend a legacy contract, that could constitute a capital sum derived from an asset, such that a charge may arise pursuant to section 22 TCGA 1992.

3. Issues arising from the withdrawal of LIBOR

Pre-transition: Hedge accounting

Q9(a) Are amendments to the hedge accounting requirements in UK GAAP and IAS sufficient to ensure that hedge accounting can continue for instruments referencing LIBOR in the pre-transition period?

32. The impact of these amendments is still being considered by our members. Although, at a high-level, the amendments appear to be helpful, the finer details are still being worked through by standard users. In particular, we would caution that any difficulties with the proposed amendments are unlikely to come to light until the relevant accounts come to be prepared. As such, we understand that in most cases, the proposed amendments have not yet been tested in practice.

Q9(b) If the amendments not sufficient to the hedge accounting requirements in UK GAAP and IAS sufficient to ensure that hedge accounting can continue for instruments referencing LIBOR in the pre-transition period, do the Disregard Regulations provide a viable solution to avoiding tax volatility?

33. As noted in paragraph 25 above, generally, taxpayers applying hedge accounting would not have considered it necessary to elect into the Disregard Regulations. Due to the strict timing conditions in Regulation 6A(2)(b), where an election had not been made prior to the taxpayers' entry into the legacy contract, (in the absence of a concession from HMRC) it would not subsequently be possible to elect into the Disregard Regulations. Accordingly, if hedge accounting was disapplied, recourse to the Disregard Regulations (as currently drafted) would not be available for those taxpayers who may wish to the avail of the regime.

34. Should there be circumstances where proposed accounting amendments were not sufficient to prevent hedge accounting being disapplied, taxpayers would benefit from maximum flexibility in managing the resulting tax implications. We consider that such flexibility would be substantially increased if the proposals in paragraphs 25(a) and (b) above were adopted.

The transition from LIBOR

Q11(a) Are there situations where you expect significant gains or losses to be recognised in profit and loss accounts as a result of restructuring financial instruments for the withdrawal of LIBOR?

35. The exact exposure of each of our members to legacy contracts constitutes market sensitive information. This is likely to be the case for many affected taxpayers. We would therefore caution HMRC against concluding that a lack of responses to this question (and in particular, a lack of detailed responses) indicates that there is no problem.

36. Notwithstanding the above, existing contracts referencing LIBOR are understood to have an aggregate value in the hundreds of trillions of pounds. Our combined membership includes many of the world's largest financial institutions whose contracts are, in aggregate, likely to represent a material portion of this sum. On an individual basis, the aggregate value of members' legacy contracts within the scope of UK tax is likely to be extremely significant. Even very minor value transfers may therefore result in significant gains or losses in absolute terms.

37. Many of these legacy contracts are accounted for on a fair value basis. The IASB is not proposing to offer any accounting relief in this context, with the result that such gains and losses will be recognised in the profit and loss statement.

Q11(b) If so, do you expect these amounts to be brought into account for tax? If not, please explain the reason for this.

38. We would generally expect such gains and losses recognised in the profit and loss statement to be brought into account for tax purposes under Parts 5 and 7 CTA 2009. We would caution, however, that the exact treatment of gains and losses will depend on our members' particular circumstances.

Q11(c) If you do expect amounts to be recognised in the accounts and brought into account for tax, do you expect this to cause any significant issues?

39. Benchmark reform represents a very significant once-off event, which our members have neither chosen, nor can avoid. As indicated in our response to question 11(b), it may result in significant (non-ordinary course) sums being recognised in profit and loss statements. Where gains / credits are recognised, it is expected that they would be brought into the charge to tax. However, where losses / debits are recognised, quantitative restrictions to the loss-carry forward rules (pursuant to Part 7ZA CTA 2010) may significantly impede our members' ability to utilise these losses. This risks creating asymmetry in the net impact of benchmark reform, to taxpayers' detriment.

Q12 – Are there any additional significant tax issues which could arise as a result of the withdrawal of LIBOR?

40. Please see paragraphs 18 to 31 above.

Post-transition issues

Q13 Are there any additional significant tax issues which could arise as a result of the withdrawal of LIBOR?

41. As noted in paragraph 24 above, where a taxpayer applies hedge accounting, any divergence between amendments made to a legacy hedged instrument, and the related legacy hedging instrument, may increase hedge ineffectiveness. Such divergences could arise because of there being different counterparties to the instruments. However, more fundamentally, they could also arise due to differences in market standard adjustment terms across different currencies (e.g. sterling versus US dollar markets) and products (e.g. derivatives versus bonds or loans). The table below, for example, sets out general indications of sterling market preferences regarding adjustment terms for legacy instruments, based on responses to consultations from regulatory and trade bodies, and (limited) reported transactions. Even where there is general consensus on adjustments, there appears to be some divergence on technical aspects of the calculations as between different products. This means that, even where parties adopt market standards, some increased hedge ineffectiveness may occur.

	Term adjustments	**Spread adjustments**
Bonds	RFR compounded in arrears (over "observation period" 5 business days ahead of interest period)	Forward spreads between LIBOR and RFR

Derivatives[6]	RFR compounded in arrears (over "observation period" 2 business days ahead of interest period)	Median spread between LIBOR and RFR over 5 year look-back period
Loan	RFR compounded in arrears (No consensus on observation period)	Median spread between LIBOR and RFR over 5 year look-back period

42. Where there is hedge ineffectiveness in hedging arrangements, market value changes are required to be brought into account in the profit and loss statement (to the extent of the ineffectiveness). Therefore, increased hedge ineffectiveness is likely to result in increased tax volatility.

43. Unfortunately, the overall tax impact of such volatility isn't just a timing point. While increases in market value recognised in the profit and loss statement due to this ineffectiveness will generally be taxable, the loss-carry forward rules (discussed in paragraph 39 above) may limit the ability to utilise any tax benefits arising from a reduction in market value.

[6] Please note that different conventions apply for new, rather than legacy, derivatives.

Annex 2

Comments on draft guidance

This draft guidance paper explains HMRC's view on the tax implications of changes to financial instruments driven by benchmark reform. If you have any comments on the draft guidance, for example additional issues that should be included or points that could be expressed more clearly, these should be sent to Oli Jones by oli.jones@hmrc.gov.uk by 28 May 2020.

London Inter-bank Offered Rate (LIBOR) 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 a large number of loans, derivatives and other financial instruments.

Publication of LIBOR is expected to cease after 2021. Consistent with a report by the Financial Stability Board in July 2014, attempts have been made to try to anchor LIBOR submissions and rates to actual transactions to ensure the sustainability of the rate. While significant improvements have been made to the benchmark since then, the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is no longer sufficiently active.

In a speech in 2017 the FCA indicated publicly that they do not intend to use their powers to compel panel banks to contribute to LIBOR after end-2021. Panel banks have voluntarily agreed to continue providing submissions to LIBOR until then, but its publication cannot be guaranteed beyond this date. Parties to financial instruments which use LIBOR as a reference rate will therefore need to transition to using alternative reference rates.

In advance of this, it is likely that banks will contact affected parties to discuss their plans to either:

- change the terms of any existing financial instruments that use LIBOR
- replace them with new instruments that do not use LIBOR

This paper explains HMRC's view on the tax implications ~~for businesses~~ of changes to financial instruments driven by benchmark reform. It is of a general nature and is based on the law as at the date of publication.

Although this guidance refers specifically to LIBOR, other benchmark rates are also being withdrawn or otherwise reformed (for example, EONIA, the US Effective Federal Funds Rate and EURIBOR). Businesses may therefore also be looking to restructure financial instruments which contain references to these other reference rates. The guidance below applies equally in those situations.

This guidance applies to changes to financial instruments where they make amendments to:

- replace the benchmark rate they refer to
- introduce or amend 'fall-back' provisions that determine how the contract should operate if the designated benchmark rate is permanently discontinued, is considered unrepresentative or otherwise cannot be used
- make incidental amendments that are consequential to replacing the benchmark rate - for example making amendments to the ~~loan~~applicable interest margin or making additional payments to broadly preserve the parties' economic position

Contracts may be amended as a result of direct negotiation, changes in a bank's standard terms and conditions, or through the parties adopting industry standard language, such as ~~the~~ ISDA's Benchmark Supplement to the 2006 ISDA Definitions and related Protocol for derivatives~~.~~ or Loan Market Association template terms for loans.

Businesses will need to consider their own circumstances carefully and make sure that any specific statutory provisions that are relevant are applied as appropriate. In cases where there is, or may have been, avoidance of tax, the application of the law (including anti-avoidance provisions) may result in a different tax treatment.

If you are not sure of the steps you need to take in relation to tax, then you should discuss this with your Customer Compliance Manager or contact HMRC if you do not have one.

It is the responsibility of the business or individual to prepare accounts in accordance with generally accepted accounting practice and submit a Corporation Tax return or Income Tax return as appropriate.

What might replace LIBOR

There are a number of existing interest rate benchmarks which could replace LIBOR in a financial instrument.

The Sterling Risk Free Rate Working Group has recommended the Sterling Overnight Index Average (SONIA) as its preferred risk free rate to replace sterling LIBOR. It is calculated by looking at the rate paid by banks on overnight funds and therefore needs to be aggregated in some way to be used over a term interest period. Similar benchmarks have been recommended for different LIBOR currencies, for example Secured Overnight Financing Rate (SOFR) for the US dollar and Swiss Average Rate Overnight (SARON) for the Swiss franc.

Restructuring a financial instrument: amounts recognised in profit or loss

If the terms of a financial instrument are amended, the way this is treated in the accounts could affect the tax treatment.

There are specific provisions in the Corporation Tax rules for companies that cover the taxation of financial instruments. These are:

- loan relationships (Part 5 of the Corporation Tax Act 2009)
- derivative contracts (Part 7 of the Corporation Tax Act 2009)

You can find more information in the Corporate Finance Manual about loan relationships and derivative contracts.

The general rule is that the amounts to be brought into account for tax under these provisions are the amounts that are recognised in determining a company's profit or loss for the period.

There can be exceptions to this general rule, where the tax treatment deviates from the accounting treatment in specific circumstances. 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. In addition, impairments of connected company debt, and losses arising on the disposal of such debt, are not brought into account for tax.

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 in a similar way. It should be noted that there are certain differences – for example, under the Income Tax rules payments will not be deductible if they are capital in nature (section 33 of the Income Tax (Trading and Other Income) Act 2005).

As a result, under both Corporation Tax and Income Tax rules, where the terms of a loan or derivative are amended to use a new interest rate, the tax treatment for the business will typically depend, in part, on the accounting treatment. Where an amount is recognised in the income statement, this will typically be brought into account for tax purposes.

For example:

- where the restructuring represents a substantial modification for accounting purposes, the company may be required to derecognise the old financial instrument and recognise the revised instrument based on its fair value at the time of the transaction – this may result in a profit (gain) or loss in the income statement
- where the restructuring represents a non-substantial modification for accounting purposes, the company may be required to recognise the difference in expected cash flows as a profit (gain) or loss in the income statement
- where, as a result of the restructuring, the conditions for hedge accounting are no longer met, or there is increased hedge ineffectiveness, this could introduce additional volatility in the income statement

Where amounts are recognised in the income statement, these will typically be brought into account for tax purposes, although as noted 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.

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. This means that the way you account for these changes may be affected.

Amending a financial instrument - creation of a new instrument

Depending on the circumstances and terms of the legal documents involved, the amendment of a financial instrument will form either:

- the continuation of an existing financial instrument (variation of the original); or
- the creation of a new financial instrument (rescission of the original)

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 the parties agree to change the terms of the instrument for the purposes of responding to the withdrawal of LIBOR, HMRC would normally view this as a variation of the existing instrument. The amended contract should be regarded as the same contract and entered into at the same time as the original one. This would apply, for example, where the parties agree to replace LIBOR for one of the new reference rates or with a fixed interest rate. It does not matter if the spread on the instrument needs to be amended slightly, or if additional payments are made between the parties, provided the ~~economics of the transaction remain mostly the same.~~purpose of the amendment is to give effect to benchmark reforms.

Where changes to legacy contracts are not made solely for the purpose of responding to benchmark reforms, and concurrent changes are made for another purpose (unconnected to benchmark reforms), the amendments will be considered separately. While amendments made for the purpose of giving effect to benchmark reforms will benefit from this guidance, those made for an unconnected purpose will not, and will be assessed separately, to determine whether they are sufficiently material to constitute the rescission of the legacy contract.

As an operational matter, financial institutions may record or "book" amendments to legacy contracts on their systems by cancelling an existing systems booking and booking a 'new' transaction in the system with a new transaction date but (with the exception of changes made for the purpose of implementing benchmark reform) the same parameters as the 'old' transaction. The manner in which amendments to legacy contracts are booked in such systems will not be a relevant factor in determining whether changes constitute a variation to, or the rescission and replacement of, a financial instrument.

There are a number of taxation provisions where ~~this~~the above-mentioned analysis will be relevant, and some of these are set out below in more detail. These are simply examples, and the analysis should also apply more generally to a wide range of additional provisions where it is necessary to determine whether a financial instrument that is amended as a result of the benchmark reform constitutes a variation or rescission of the original financial instrument.

Where 'fall-back' provisions come into operation according to the existing terms of the agreement this will not be not regarded as an amendment to the contract, and it will not be necessary to consider whether there has been a variation or whether a new contract has been created.

Taxation provisions

Capital gains tax

HMRC would not expect amendments made for the purpose of responding to benchmark reform to trigger a disposal (or part disposal) for capital gains tax purposes. So, for example, if an individual holds a financial instrument which is amended for this purpose, HMRC would not normally expect a chargeable gain or loss to accrue as a result.

The Disregard Regulations

The Disregard Regulations (S.I. 2004/3256) allow a company to disregard certain fair value movements that arise on a derivative contract that is hedging particular risks, provided a valid election has been made and certain conditions are met.

The Disregard Regulations apply where a hedging instrument is intended to act as a hedge of a hedged item. It is possible that references to LIBOR in the hedging instrument will be amended at a different time to references to LIBOR in the hedged item and they could even be replaced with different rates. Despite this, the Disregard Regulations can still apply provided the intention to hedge remains. It does not matter that there is no longer a perfect hedge going forwards or that there is an increased level of hedge ineffectiveness.

Grandfathering

In some circumstances legislation provides particular treatment for instruments entered into before a specific date. This means a historic tax treatment still applies to an existing instrument even though the tax treatment changes for new instruments entered into after a specific date. This is known as 'grandfathering'. Where a financial instrument benefits from a grandfathered treatment, HMRC would normally expect this treatment to continue where amendments are made for the purpose of responding to benchmark reform as outlined above.

There are a few grandfathering provisions where this could apply. For example:

- the 'qualifying old loan relationship' rules that only apply to loans entered into on or before 12 May 2016
- changes made to the loan relationship and derivative contract regimes by Finance (No.2) Act 2015
- certain leasing provisions

Making an additional payment

One party might need to make a one-off payment, or series of payments, to the counterparty to compensate for the changes in terms when the ~~financial~~legacy instrument is amended to respond to benchmark ~~form~~reform. Who receives this payment depends on how the expected cash flows under LIBOR compare with the expected cash flows under the new reference rate. For example, if the ~~financial~~legacy instrument was a loan and the expected cash flows representing payments of interest are lower under the new reference rate, you would expect the borrower to make a payment to the lender for the shortfall.

It is necessary to consider the nature of this payment, and this will depend on ~~which~~the nature of the legacy contract, the party which is making the payment, and the reason for the payment.

For example, if the legacy contract is a loan, and the borrower makes a payment to the lender~~,~~ in respect of a change to the way interest is calculated, this would normally be treated as interest because it will meet the hallmarks of interest (see CFM33030). In particular, the amount represents compensation for the use of the money advanced by the lender. The borrower may have to deduct Income Tax on the payments in a similar way to the ordinary payments of interest on the instrument. Any exemptions or reliefs applying to interest payments under the instrument (e.g. treaty clearances) will apply equally to the additional payment.

However, if a lender has to make a payment to the borrower, this cannot be interest because the lender does not have the use of any money and so cannot be compensation for the use of money. Instead, this payment is likely to be an expense incurred by the lender to make sure the borrower continues to make interest payments considering that these will now have increased. It is unlikely the lender will need to deduct Income Tax on any such payment because such an expense should not fall within Part 15 of the Income Tax Act 2007.

In cases where the additional payment relates to a derivative contract by a company, such a payment would be exempt from the requirement to deduct Income Tax under section 980 of Income Tax Act 2007.

If the legacy contract is a lease, and an additional payment is made to compensate for changes to the manner in which rental payments are calculated, the additional payment would normally be treated as (a) a rental payment if made by the lessee or (b) a rental rebate, if made by the lessor. Again, the payment will not fall within Part 15 of the Income Tax Act 2007, and the payer will not be required to apply withholding tax.

Where the payment is recognised in the income statement, that amount would normally be brought into account for tax purposes. For companies, this is likely to be under either the loan relationship or derivative contract regimes, depending on the type of financial instrument. For other businesses, this is likely to be under the rules for trades or property businesses.

For VAT purposes, the additional payment will be treated as an adjustment to the consideration for the original supply. Where, for example, the original supply was exempt (as would be the case for the legacy contracts which are derivative contracts, loans or notes), the additional payment will not be subject to VAT, or otherwise have any VAT consequences. For amendments to leases, the VAT treatment would depend on (i) whether the relevant property was opted to tax, and (ii) whether the payment constituted an additional rental payment, or a rebate.

Double Taxation Treaty Passport Scheme

If a UK company borrows from an overseas lender it should deduct amounts representing Income Tax at the basic rate when it makes interest payments to the lender. HMRC operate a number of schemes which allow payments to be made gross including the Treaty Passport Scheme and the Syndicated Loans Scheme.

If a loan falls under either of these schemes, and there is a material change to the terms or ownership of it, the lender or syndicate manager should notify HMRC to make sure that payments can continue to be made gross. Sections DTTP30410 and DTTP30420 of the Double Taxation Treaty Passport Scheme explain what constitutes a material change. HMRC would normally expect that changes to an agreement for the purposes of responding to benchmark reform would not amount to a material change and there should therefore be no need to contact HMRC. Equally, such changes should not impact a treaty direction which is already in place and there should therefore be no need to make a fresh treaty clearance.

Reporting requirements

Businesses must comply with certain reporting requirements such as the EU Mandatory Reporting rules (DAC6) and the International Movement of Capital regulations. Where such

requirements depend on a new financial instrument being created, HMRC would expect that amendments made for the purpose of responding to benchmark reform as outlined above should not create a new financial instrument. There should therefore be no requirement to make a report under such provisions and in such circumstances.

Stamp Duty and Stamp Duty Reserve Tax

A transfer of loan capital is exempt from Stamp Duty and Stamp Duty Reserve Tax if the interest rate on the capital does not exceed a reasonable rate of return.

HMRC does not expect that changes to a financial instrument for the purposes of responding to benchmark reform as outlined above should by themselves have any impact on this exemption because this condition is tested at the point that the right to interest is created. It would not normally be necessary to revisit this test on the amendment to the reference rate. Find more information in the Stamp Taxes on Shares Manual (STSM41060).

Company distributions

Where a company makes payments of interest that exceed a commercial rate on the principal secured, this may be treated as a 'distribution' by paragraph E of section 1000(1), CTA 2010 with the result that no tax relief would be available for this amount. A material change in the terms of a security can cause the analysis of whether a payment in respect of that security comes within paragraph E to change. However, HMRC would expect that amendments made for the purpose of responding to benchmark reform as outlined above will not itself constitute a material change.

"Equity holder" status

In order to qualify for group relief, certain tests must be met regarding the degree of connection between entities. These include conditions regarding entitlements to assets and profits, which in turn require an entities' "equity holders" to be identified. There are circumstances where a lender of a loan to an entity could constitute one of its "equity holders". This may be the case if a loan carries a right to interest which exceeds a reasonable commercial return on the new consideration lent - as such loan would not constitute a "normal commercial loan" within the meaning of section 162 CTA 2010 (see further CTM81010). HMRC does not expect that changes to a financial instrument for the purposes of responding to benchmark reform as outlined above should by themselves have any impact on the question of whether a loan carries more than a reasonable commercial return for this purpose. This is because this is tested at the point that the right to interest is created, when the legacy contract was first entered into.

Transfer pricing

In certain cases, if a company enters into financial instruments with an associate person, the UK transfer pricing rules require the taxable profits to be calculated on the assumption that that financial instrument was on 'arm's length' terms.

In many cases, the arm's length price of financial instruments may have been specified by reference to LIBOR. For example, the arm's length interest rate charged on intra-group loans

may have been based on LIBOR plus a margin. There may also have been references to LIBOR used to decide on the arm's length price of non-financial contracts.

HMRC will normally accept that parties to a contract that references LIBOR would, acting at arm's length, agree to make changes to the contract to respond to the reform of the benchmark. It would not normally be necessary to reassess whether the terms of the original agreement are arm's length as this is tested at the point the provision was originally entered into.

Groups should:

- document their transfer pricing methodology to make sure the amounts reflected in their tax computations are supported by following Organisation for Economic Co-operation and Development (OECD) guidance
- update their documentation (where relevant) to reflect the withdrawal of LIBOR from the end of 2021
- noting the above statements, make sure that any amendments to financial instruments between associated persons are undertaken on an arm's length basis.

Clearances

In some circumstances businesses can request a clearance from HMRC on the tax treatment of a particular arrangement.

Existing clearances could involve financial instruments that need to be amended to replace references to LIBOR and to respond to the reform of benchmark rates. The business may still rely on the certainty given by the clearance provided:

- the amendment to the financial instrument ~~does not affect the economics of the transaction~~is made for the sole purpose of responding to benchmark reform
- there is nothing significant in the tax analysis of the transaction that would be affected by the amendments

If the changes went wider than this, and had a material impact on the transaction which is subject to the clearance, then HMRC would no longer be bound by the clearance. Also, it would be the business' responsibility to make sure that the amendment is treated correctly.

A company can also apply to HMRC for an Advance Thin Capitalisation Agreement (ATCA) if they are concerned the transfer pricing rules might be used on a proposed funding arrangement (such as where an intra-group loan is entered into). There is more information HMRC's in International taxation manual (INTM512000).

Where an ~~ACTA~~ATCA has already been given for a funding arrangement based on LIBOR, the company will need to consider the amended terms and will need to be satisfied that the amendments to the loan agreement are undertaken on arm's length terms. In this case, the ~~ACTA~~ATCA can remain in place and the company will not need to submit a new application detailing the new terms.

The ~~ACTA~~ATCA will no longer apply if there are any other amendments to the funding arrangement.