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The Transition From LIBOR – UK Tax Impacts and Industry Reaction

The transition from LIBOR and the amendments made to financial instruments to deal with the transition have the potential to generate significant United Kingdom (UK) tax consequences for transaction parties.

In view of this, the UK tax authority, HM Revenue & Customs (HMRC), has published a consultation document setting out its views as to the main UK tax implications, and HMRC's intended approach to dealing with these implications.

The consultation is open until 28 August 2020 (representing a three-month extension to the original deadline for comments because of the COVID-19 pandemic).

Now two of the major industry bodies – the International Swaps and Derivatives Association (ISDA) and UK Finance (the major banking and finance trade body in the UK) – have submitted a joint, public response to HMRC setting out their concerns regarding the impact of benchmark reform on UK taxpayers and certain aspects of HMRC's proposed approach.

We highlight some of the key issues below.

The Starting Position: Tax Treatment Follows the Accounts

The general rule regarding the UK tax treatment of most forms of financial instruments – from plain vanilla borrowings, to complex derivatives and everything in between – is that tax follows the accounts. The amounts brought into charge for UK tax purposes are broadly the amounts recognized in determining a company's profit or loss.

For example, where an instrument is restructured for the purposes of benchmark reform and this represents a "substantial modification" for accounting purposes, the company may be required to derecognize the old financial instrument and recognize the revised instrument based on its fair value at the time of the restructuring. This may result in a profit (or loss) in the income statement.

Similarly, contractual amendments could cause transfers of value between parties. Whereas in isolation these may prove to be relatively modest, if the aggregate value of an institution's legacy contracts is significant, then even minor value transfers could result in large taxable gains.

Although the general rule works both ways – in that a tax-deductible loss could arise, rather than a gain – the UK tax rules regarding the use of losses have become more restrictive in recent years, and therefore the ability to benefit from any such loss is not guaranteed.

The International Accounting Standards Board is not yet proposing to offer any accounting relief in this context, so as matters stand, this UK tax impact could be material.

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Will Restructurings Be Treated as Creating New Agreements?

Operational Considerations

Continuity of tax treatment, and the certainty that this brings, is of the utmost importance here.

ISDA/UK Finance make the point that operational considerations may encourage parties to rebook legacy transactions, rather than merely amend an existing booking. For example, if the changes were 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.

If, for UK tax purposes, the amendment of a contract to deal with the transition from LIBOR meant that a new contract was considered as coming into existence, this could have a detrimental impact on transaction parties for UK tax purposes.

The ISDA/UK Finance position is therefore that:

- it should not be inferred from rebooking that the intention of the parties is to create a new contractual relationship; and
- the HMRC guidance should incorporate express confirmation that the manner in which amendments are booked in systems will not be a relevant factor in determining whether amendments are treated as variations to existing contracts or as giving rise to new contracts.

Requirement for Absence of Economic Impact

In their consultation document, HMRC expressed the view that they would expect to treat an amendment made to deal with the withdrawal of LIBOR as a variation of the existing instrument, "provided the economics of the transaction remain mostly the same."

ISDA/UK Finance note, however, that the market is increasingly coming to the position that some form of value transfer is inevitable, and there is therefore concern around the use of the term "mostly the same."

For example, parties may agree to 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. As this is a backward-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.

In light of this, ISDA/UK Finance propose that HMRC look solely to the purpose of the amendments – such that the sole precondition for continuity of existing tax treatment is that the relevant amendments are made only for the purposes of benchmark reform. The focus would therefore be on the underlying intention rather than the economic outcome.

From HMRC's perspective, it would be more difficult to have to determine parties' intentions as opposed to the economic outcome of their actions. So, as with all of ISDA/UK Finance's proposals, it remains to be seen whether HMRC elect to take this on board.

Timing Concerns

Any delay in obtaining certainty of UK tax treatment – whatever that treatment may be – is of concern for UK taxpayers. ISDA/UK Finance make the point that UK taxpayers may be unable to wait until the publication of final guidance from HMRC (which is likely to be at least several weeks away) before amending legacy contracts.

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In light of this, ISDA/UK Finance propose that transaction parties be entitled to act on the basis of the draft guidance, with the explicit assurance that any future changes to the guidance will not adversely affect them. ISDA/UK Finance point to the example of the United States where pending finalization of the United States Treasury regulations regarding benchmark reform, taxpayers can act in reliance on the proposed Treasury regulations.

The extent to which HMRC choose to meet the requests and suggestions of ISDA/UK Finance could materially affect the UK tax outcome of benchmark reform. For the sake of creating certainty among affected taxpayers, it is hoped that HMRC will make their position known as soon as possible once the 28 August deadline for comments has passed.

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