HM Revenue
& Customs

Taxation impacts arising from the withdrawal of LIBOR

Summary of Responses

12 November 2020

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1. Introduction

Background

1.1 LIBOR is a set of benchmark interest rates based on the rates at which banks are willing to borrow wholesale unsecured funds. It is widely used as a reference rate for loans, derivatives and other financial instruments.

1.2 Consistent with a report by the Financial Stability Board in July 2014, attempts have been made 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. Therefore, in a speech in 2017 the Financial Conduct Authority (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.

1.3 On 23 June 2020 the Chancellor made a written ministerial statement indicating that the government will ensure the FCA's powers are sufficient to manage an orderly transition from LIBOR. This will include extending the circumstances in which the FCA may require an administrator to change the methodology of a critical benchmark and providing the FCA with the ability to specify the limited, continued use of LIBOR in legacy contracts. It remains the case, however, that businesses should continue to transition away from using LIBOR as a reference rate in their financial contracts.

1.4 Projects have been under way to finalise amendments to International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Practice (UK GAAP), in order to address accounting issues that arise because of the restructuring of contracts as a consequence of benchmark reform. The International Accounting Standards Board (IASB) published the IFRS amendments on 27 August 2020. The Financial Reporting Council (FRC) in the UK has been consulting on similar changes to UK GAAP, with the consultation period closed on 30 September 2020.

1.5 Although this document refers specifically to LIBOR, similar benchmark rates exist worldwide such as Euro Interbank Offered Rate (EURIBOR) for the Euro and Tokyo Interbank Offered Rate (TIBOR) for Japanese yen. Businesses may also be looking to restructure instruments which contain references to these other benchmark rates. References to 'LIBOR' in this document should therefore be read to include other benchmark rates where relevant.

Consultation

1.6 A consultation entitled 'Taxation impacts arising from the withdrawal of LIBOR' was published on 19 March 2020. This initially set 28 May 2020 as the deadline for responses, but was extended to 28 August 2020 in consequence of the Covid-19 pandemic.

1.7 The consultation had two aims:

- To identify statutory references to LIBOR that needed amending as a result of the withdrawal and seek views on how this should be done.

- To ensure HMRC fully understands the tax impacts that could arise from the reform of LIBOR and other benchmark rates. This will inform consideration of any further response required, in addition to the legislative changes needed to address explicit references to LIBOR.

1.8 Nine responses to the consultation were received from accounting firms and professional bodies.

2. Responses

General

2.1 Respondents reported that only a minority of businesses had already decided how to deal with withdrawal of LIBOR; many businesses are awaiting further developments on the reference rates and confirmation of the changes to the accounting standards before proceeding. It was therefore considered important that HMRC continue to monitor the situation.

Draft guidance

Question 1 – Are there any additional issues that should be included in the draft guidance, or points that could be expressed more clearly?

2.1 Many respondents placed value on the draft guidance produced by HMRC and were keen that this was finalised as soon as possible. Respondents noted that many taxpayers are expected to begin their amendment process to migrate away from LIBOR in the coming weeks and months. Respondents requested that the contents of the guidance to be monitored going forwards and updated as appropriate.

2.2 Several additional issues were suggested for inclusion, and where appropriate, these were incorporated in the updated guidance published on 12 November 2020. In particular, the guidance now covers the VAT treatment of a one-off payment. The 'reporting requirements' section has also been expanded. Some additional issues raised have not been included in the update, typically because they were detailed points without widespread application. The need for additional guidance will continue to be monitored.

2.3 Respondents also requested guidance on the treatment for individuals. HMRC has as a result produced draft guidance for individuals, which was published for comment alongside the updated business guidance.

Statutory references to LIBOR

Question 2 – How common is it for companies to rely on each of the LIBOR fallback provisions in tax legislation?

2.4 None of the respondents thought the fallback provisions were commonly used. One respondent commented that they are unlikely to be necessary for lessors because they should have all the information necessary to calculate the implicit interest rate.

Question 3 – Are there any additional places where tax legislation depends on LIBOR that need updating in light of its expected withdrawal at the end of 2021?

2.5 No additional references to LIBOR in tax legislation that needed updating were identified.

Options for replacement rate

Question 4 – What do you see are the advantages and disadvantages of each option for replacing references to LIBOR in tax legislation?

2.6 Only five respondents commented on the questions in this section. Two respondents made the wider point that none of the options were similar to LIBOR and that these rates were historically lower than the prevailing LIBOR rate. They could therefore produce different results from the current rules.

2.7 One respondent said that the current use of LIBOR and all three options presented in the consultation were somewhat arbitrary because they fail to take into account the characteristics of the lessee, for example the credit risk.

Option (1) – overnight rate

2.8 Respondents said the main advantage of using the overnight rate is that this is the preferred replacement rate identified by the Working Group on Sterling Risk-Free Reference Rates (RFRWG). Respondents also said it was the most straightforward to apply and reflects the recommended commercial response to benchmark change.

Option (2) – term reference rate

2.9 No advantages were put forward for option two. Respondents felt this went against the recommendation of RFRWG. It was also noted that the term reference rates are still in development, and are only expected to be available for certain currencies.

Option (3) – sovereign rate

2.10 No advantages were put forward for option three either. Respondents questioned how to determine which sovereign rate to use when the instrument was denominated in Euro as there are multiple countries which issue government debt in Euros, with differing interest rates.

Question 5 – Comparing the three options, what is your preferred option and why?

2.11 Three respondents said that the overnight rate (option one) was the best option of the three. The remaining two respondents said none of the options were suitable and that the 'incremental borrowing rate' should be used instead. This is discussed further at paragraph 2.12 onwards.

Question 6 – Are there any other options that should be considered?

2.12 Three respondents suggested that LIBOR could be replaced with the 'incremental borrowing rate' as defined by generally accepted accounting practice. This is a concept used by both IFRS and UK GAAP. IFRS 16 defines this rate as:

> *"The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the [right-of use asset] in a similar economic environment."*

2.13 Respondents said lessees are familiar with using this rate in calculations and that aligning the tax treatment with the accounting treatment would reduce compliance burden.

Question 7 – Do you think changing statutory references will have any impact on your administrative burdens and costs? If so, please provide details including any one-off and on-going costs.

2.14 None of the respondents thought changing the statutory references would have any impact on administrative burdens given how infrequently the provisions are used.

2.15 One respondent did make the wider point about the transition away from LIBOR having a compliance burden on businesses. In particular, they noted that transfer pricing agreements which used LIBOR as a reference rate would need to be amended and this would involve a one-off cost for affected businesses.

Question 8 – Do you think changing statutory references will have any additional impact on small and micro businesses, not already covered? If so, please provide details, including any one-off and on-going costs.

2.16 None of the respondents identified any additional impacts on small and micro businesses.

Pre-transition: Hedge accounting

Question 9 – In the context of this issue:

a) Are the 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?

b) If the amendments are not sufficient, do the Disregard Regulations provide a viable solution to avoiding tax volatility?

2.17 The proposed ‘Phase One’ accounting amendments aim to allow continuation of hedge accounting despite uncertainty caused by the announced withdrawal of LIBOR. Respondents said that they are expected to cover most hedging relationships up to the point at which instruments are amended or replaced.

2.18 Respondents also noted that issues about the continuation of hedge accounting could arise where existing instruments are amended or replaced as part of the transition away from LIBOR or other benchmark rates. It was noted that the ‘Phase Two’ accounting changes should mean that there will be no need to discontinue hedge accounting for the vast majority of hedging relationships.

2.19 However, it was noted that there are some situations where the Phase Two accounting changes would not apply, for example where a contract is closed out and replaced.

2.20 Respondents said hedge ineffectiveness could increase if the hedging instrument and hedged item are amended in different ways or at different times, which could happen when there are different counter-parties to the instruments. This could also arise due to differences in market standard adjustment terms across different currencies and products.

2.21 In certain cases, this could lead to discontinuation of hedge accounting, particularly under IAS39 (given its ‘bright line’ effectiveness threshold of 80%-125%). Even where hedge accounting continues, this could result in increased tax volatility. Respondents commented that it appeared the IASB is not intending to make any accounting amendments to cover this potential issue.

2.22 Some of the respondents commented that, while the Disregard Regulations could potentially provide a solution, in practice they are unlikely to do so because of the time limits for making an election under regulation 6A. The Disregard Regulations would therefore need to be amended if they were to provide a viable solution for such cases. However, respondents said it was difficult to know if this would be an issue in practice given that the majority of businesses have yet to transition. It was also noted that any tax volatility would normally be a timing mismatch only.

Question 10 – Do any additional significant tax issues arise pre-transition?

2.23 Respondents were not aware of any other significant issues.

The transition from LIBOR

Question 11 – In the context of transactions undertaken to restructure financial instruments for the withdrawal of LIBOR:

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?

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

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?

2.24 Respondents said it was unlikely that significant amounts would be recognised given the 'Phase Two' accounting amendments, but noted it was difficult to answer this with any certainty until businesses actually started to transition. They also made the point that the total of legacy contracts is valued in the trillions of pounds and even small amounts in relative terms could result in significant amounts in aggregate.

2.25 It is also possible that the accounting easements under Phase Two will not apply in certain situations, meaning gains or losses were more likely to be recognised in these cases. For example, one respondent said that companies might make additional changes that did not relate to LIBOR reform at the same time as they transitioned away from LIBOR. Doing so could save both time and money. However, these changes may not be covered by the Phase Two accounting easements, and could therefore result in amounts being recognised earlier than they would have been in the absence of LIBOR reform. It was also noted that the Phase Two changes would not assist with transactions undertaken before the accounting changes have effect.

2.26 Respondents agreed that the tax treatment would generally follow the accounting. However, respondents noted that the amounts to be brought into account for tax would depend on the particular circumstances in question. In particular, it was noted that the amounts recognised in the accounts may not be brought into account for tax if the parties are connected. Respondents considered that this could create a mismatch between group companies.

2.27 One respondent noted that any amounts that are recognised in the accounts and brought into account for tax would probably result in a timing difference only, as any credit arising on transition would arise on the date of the transaction and typically be unwound over the remaining life of the loan. However, another respondent noted that the impact may be more than just a timing difference in cases where the loss carry-forward rules are in point. Another respondent noted that capital gains tax may be triggered earlier than would otherwise have been the case.

Question 12 – Are there any other significant tax issues that could arise as a result of the restructuring of financial instruments for the withdrawal of LIBOR?

Question 13 – Are there any additional significant tax issues which could arise as a result of the withdrawal of LIBOR?

2.28 A number of comments were made by respondents, largely building on the points identified in the draft business guidance. On the whole, respondents thought that the position adopted by HMRC in the guidance was helpful, but had concerns around the limitations of the guidance and wanted it to go further.

2.29 A key element of the guidance concerns the question of whether a transaction to restructure a financial instrument constituted the continuation of an existing instrument, or the revocation of an existing instrument and the creation of a new one. It was noted that guidance was predicated on the assumption that the economic position after the transaction is broadly equivalent to that prior to the transaction. While the guidance was considered helpful as far as it went, respondents were concerned at the need to assess this economic qualifier. It was noted that it would be simpler to determine the correct tax treatment if the 'purpose' of the transaction was the sole criterion applied.

2.30 Likewise, it was noted there are concerns that HMRC may look at the legal form of the transaction, and that there may be an additional burden for taxpayers if the continuity of tax treatment is dependent on a particular amendment process being followed. The burden could be significantly lightened if the approach taken is to look at the purpose of the amendment.

2.31 Respondents also identified there could be an issue with hybrid mismatch rules. This could be the case if different jurisdictions deal with the transition in different ways or at different times. One of the respondents asked HMRC to consider amending the 'permitted time period' rules to provide clarity that they can be applied in cases where a business is migrating away from LIBOR or another benchmark rate.

2.32 Respondents reiterated that only a minority of businesses had already decided how to deal with the withdrawal of LIBOR; many businesses are awaiting further developments on the reference rates and confirmation of the changes to the accounting standards before proceeding. Therefore, it was considered important for HMRC to continue to monitor the situation.

3. Government response

Guidance updates

3.1 The business guidance that was published in draft on 19 March 2020 has been amended to take account of comments received where appropriate to do so. The updated business guidance was published on 12 November 2020.

3.2 Guidance for individuals has also been prepared and was published on 12 November 2020 for comment.

3.3 It was not possible to update the guidance in line with the comments received in every case. In particular, it is not possible for HMRC to include in the guidance situations where the economic effect of the post-transaction instrument would not be broadly equivalent to the pre-transaction instrument.

3.4 Only points with reasonably widespread application are included in the HMRC guidance. It can be difficult for HMRC to comment on less common issues outside of the context of their particular facts. It would also make it more difficult for businesses to access the key points being made in the guidance.

3.5 HMRC will continue to keep the guidance under review in light of points identified in the consultation as businesses transition away from LIBOR and other reference rates in the coming months. HMRC will update the guidance should it be appropriate to do so.

Legislative amendments to the leasing rules

3.6 In light of the comments received, the government will replace the references to LIBOR in the leasing provisions with references to the ‘incremental borrowing rate’ in line with the accounting standards dealing with leases.

3.7 It was not considered appropriate to use SONIA (and its equivalent for other currencies) as the replacement given that these are backwards looking rates. While they are now more commonly being used in financial instruments to calculate interest instead of LIBOR, they are less appropriate where the rate is being used as part of a notional calculation to discount future cashflows.

3.8 We also consider that the term reference rates or sovereign rates are not ideal replacements for the reasons cited by the respondents.

3.9 The ‘incremental borrowing rate’ appears to be relatively straightforward to use. In particular, it should be a rate that businesses preparing their accounts under GAAP will already have been required to calculate. It also reflects businesses’ particular circumstances, and so could be seen as a better rate for use in discounting the future cashflows under the lease.

3.10 The government will also introduce a power to allow the rate specified in legislation to be updated through regulations if this should prove necessary, for example due to a change in accounting standards. There are currently no plans to use this power.

3.11 Draft legislation to replace the references to LIBOR in the leasing rules has been published alongside this document for inclusion in Finance Bill 2021.

Other legislative changes

3.12 There were limited requests for other specific legislative changes. However, the government does not intend to make any further substantive legislative changes at this time. The reasons for this are set out below.

3.13 Some of the respondents noted that the time limit for making elections under the Disregard Regulations is likely to have passed for existing derivatives, and therefore many companies may not be able to access the rules in the Disregard Regulations (in particular, regulation 9). However, it was noted that the 'Phase Two' accounting changes should mean that there will be no need to discontinue hedge accounting for the vast majority of hedging relationships.

3.14 It would not be straightforward to extend the deadline for making elections in a way that protects the Exchequer from companies using the benefit of hindsight to pick the most favourable position for them. Any solution was therefore unlikely to be administratively simple for affected companies. On balance, therefore, it is not considered appropriate to extend the deadline for electing into the Disregard Regulations.

3.15 One respondent asked for a specific provision to be introduced in the hybrid mismatch rules to ensure that the 'permitted time period' provisions can be applied in cases where instruments are being transitioned away from LIBOR and other benchmark rates. However, we consider that such a legislative change is unnecessary given that the rules already allow businesses to make an election into these provisions where it is just and reasonable to do so. The business guidance has been updated to highlight the availability of this election.

3.16 The government is aware that many businesses have not yet started to migrate their financial contracts away from LIBOR and other benchmark rates. It is therefore possible that further issues could emerge in the future. HMRC will continue to monitor the issues that businesses are facing, and will assess whether further legislative amendments are required where the impacts are substantial.

3.17 To allow for the option of making any necessary legislative change outside of the Finance Bill cycle, the government has decided to introduce a time-limited power to make secondary legislation to address any unforeseen issues arising from the transition away from LIBOR and other benchmark rates. It is not anticipated that the government will need to use this power. However, the government considers it necessary and prudent as protection in case legislative change is needed for transactions being undertaken in the run up to 31 December 2021.

3.18 Draft legislation to introduce this power has been published alongside this document for inclusion in Finance Bill 2021.

Annexe A: List of respondents

Association of British Insurers (ABI)

Association of Chartered Certified Accountants (ACCA)

British Vehicle Rental and Leasing Association (BVRLA)

Deloitte

EY

International Swaps and Derivatives Association (ISDA)

KPMG

Loan Market Association (LMA)

PwC

UK Finance