Inter-bank Offered Rate (IBOR) reform

Reforms to the IBOR may have tax implications for business if changes are made to existing financial arrangements.

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About IBOR reform

Find out about the background to IBOR reform and who should use this guide.

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Common tax implications of changes made to financial arrangements due to Inter-bank offered rate (IBOR) reform.

What is IBOR reform?

IBORs, including the London Inter-Bank Offered Rate (LIBOR), Euro Inter-bank Offered Rate (EURIBOR), and the US Effective Federal Funds Rate are interest rate benchmarks. They are commonly used to determine interest rates and payment obligations for a wide range of financial arrangements such as loans, bonds and derivatives.

IBORs are at various stages of reform to transition to alternative near Risk Free Rates (RFRs), such as the Secured Overnight Financing Rate (SOFR) for USD, Euro Short-Term Rate (€STR) for EUR and Sterling Overnight Inter-bank Average Rate (SONIA) for GBP. In particular, LIBOR, one of the most widely used IBORs in financial markets, ceased to be published in a number of currencies at the end of 2021.

Transitioning to RFRs is a complex process as RFRs are structurally different from IBORs. It is expected most financial arrangements that provide for IBOR-based payments will need to be modified to accommodate this transition.

Businesses may be looking to modify the contracts of impacted IBOR-based financial arrangements by:

- replacing the existing benchmark rate in the relevant agreement with an alternative RFR
- amending existing fallback clauses or introducing fallback clauses where they do not currently exist
- making other incidental variations to contracts as a direct consequence of IBOR reform, such as additional payments or credit spread adjustments to be made for the purposes of preserving the parties' economic positions.

Who should use this guide

This guide applies to you if you make changes to the contractual terms of your financial arrangements due to IBOR reform. That is, you make changes to your contracts for the sole purpose of responding to a transition from a particular IBOR to an alternative RFR or other replacement benchmark rate.

This guide does not cover tax consequences associated with amendments made to financial arrangements which do not relate to IBOR reform.

Examples of changes which are likely to be driven by IBOR reform include:

- the implementation of market conventions applicable to the RFR or replacement rate into the contract, such as amending or incorporating fallback clauses (or market disruption provisions) for a temporary or permanent RFR or other IBOR replacement rate unavailability scenario, and
- making other incidental variations to contracts as a direct consequence of IBOR reform. such as additional payments (or credit spread adjustments) to be made for the purpose of preserving the

parties' economic positions and reducing or eliminating (to the extent possible) any potential transfer of economic value from one party to another as a result of the transition from IBOR to replacement rates. In making changes to legacy contracts as a result of IBOR reform, parties may choose to adopt market consensus in terms of standard language and IBOR fallback rate adjustments consistent with published international guidance by relevant industry and regulatory bodies, including:

- the Alternative Reference Rates Committee, including its Guiding Principles
- the Working Group on Sterling Risk-Free Reference Rates
- the Working Group on Euro Risk-Free Reference Rates
- the National Working Group on Swiss Franc (CHY) Reference Rates
- the Cross-Industry Committee on Japanese Yen (JPY) Interest Rate Benchmarks
- the International Swaps and Derivatives Association (ISDA), including the ISDA 2020 IBOR Fallbacks Protocol and the Fallback Supplement to the 2006 ISDA Definitions
- Bloomberg, including its IBOR Fallback Rate Adjustment Rule Book
- the Loan Market Association (LMA), including its template terms.

If you are a party to a financial arrangement impacted by IBOR reform, you need to be aware of the tax consequences. These will vary depending on the nature of your circumstances. You may want to seek professional tax advice to help you to make an informed decision as to the tax effect of any amendment you make to your contracts due to IBOR reform.

This guide is of a general nature and is based on the law and the ATO's understanding of the state of play in relation to IBOR reform as at the date of publication.

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LIBOR and Australian benchmark reform

Inter-bank Offered Rates (IBOR), such as the London Inter-bank Offered rate, are in the process of being reformed.

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LIBOR

Australian benchmark reform

IBORs such as LIBOR have been reformed, or are in the process of being reformed.

LIBOR

A number of LIBOR rates either ceased to be published or representative as of 31 December 2021.

LIBOR was historically one of the most widely used IBORs in financial markets, and previously quoted for five currencies (USD, GBP, CHF, JPY and EUR) in seven tenors (overnight, one week, and one, two, three, six and 12 months). It was commonly used in financial arrangements, including loans, derivative (including hedging) arrangements, internal pricing and other financial arrangements.

On 5 March 2021, the FCA formally announced that all LIBOR settings for all currencies will either cease to be provided by any administrator or no longer be representative immediately after the following dates:[1]

- 31 December 2021 for all GBP, EUR, CHF and JPY LIBOR settings in all tenors (overnight, one week, and one, two, three, six and 12 months), and USD LIBOR one-week and two-month settings
- 30 June 2023 for USD LIBOR overnight and one, three, six and 12-month settings.

To avoid disruption to financial markets, the FCA has also confirmed[2] that it will require the continued publication of certain LIBOR settings for the duration of 2022 on a 'synthetic' basis for certain legacy contracts.

In Australia, financial regulators have strongly encouraged financial market participants to prepare for the transition away from LIBOR; for example, by adopting alternative RFRs that is best suited to each product and service and appropriate to their clients' need for financing or hedging strategies and including robust fallback clauses in existing contracts.[3] In this regard, ASIC (with the support of APRA and the RBA) has strongly advised Australian financial and corporate institutions to adhere to the 2020 IBOR Fallbacks Protocol and associated Supplement released on 23 October 2020.[4]

For certain currencies, other local IBOR benchmarks are used such as EURIBOR and EONIA for EUR, and the Tokyo Interbank Offered Rate (TIBOR) for JPY. These IBORs are also being reformed, for example, via improvements to their calculation methodology, or alternatively replacement with alternate RFRs.

Australian benchmark reform

For the Australian dollar (AUD), the key interest rate benchmarks are the Bank Bill Swap Rates (BBSW) and the RBA Inter-bank Overnight Cash Rate (Cash Rate or AUD Overnight Index Average (AONIA)). The BBSW is a credit-based short-term interest rate used as a benchmark for the pricing of the AUD derivatives and securities, while AONIA is the interest rate on unsecured overnight loans between banks and is considered the RFR for the AUD.

Reforms have also been undertaken to enhance the robustness of these benchmarks, including changes in recent years to strengthen the methodology underlying the benchmark calculation of the BBSW. Accordingly, the RBA has indicated that regulators in Australia will be facilitating a 'multi-rate' approach, where Australia's local credit-based benchmark (the BBSW) will co-exist with Australia's RFR (AONIA) as the key benchmarks for the AUD.
FCA 2021, Announcements on the end of LIBOR, press release, 5 March.

1

FCA 2021, Further arrangements for the orderly wind-down of LIBOR at end-2021, press release, 29 September.

2

Australian Prudential Regulation Authority (APRA), Australian Securities and Investments Commission (ASIC) and Reserve Bank of Australia (RBA) 2020, Regulators Release Feedback on Financial Institutions' Preparation for LIBOR Transition, joint media release, Sydney, 8 April.

3

APRA, ASIC and RBA 2020, Regulators urge Australian institutions to adhere to the ISDA IBOR Fallbacks Protocol and Supplement, joint media release, Sydney, 13 October.

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General income tax considerations

Businesses should consider the income tax effect of changes made to existing financial arrangements due to IBOR reform.

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Amending or creating contracts

Depending on the terms and conditions of the legal contracts involved, as a matter of contract law, the amendment of a legal contract will result in either the:

- continuation of the legal contract (that is, a variation of the existing contract), or

- creation of a new legal contract (that is, a rescission of the existing contract).

The intention of the parties as reflected in the amendments to the legal contract[1], and the significance of the amendments in altering the substance of the original contract[2], will be significant factors in determining whether the changes constitute a variation of an existing legal contract or the redemption and replacement of an existing legal contract. This is a question of fact to be determined by reference to all the facts and circumstances of each case.

Where the parties agree to change the terms of the contract for the sole purpose of responding to IBOR changes such as the withdrawal of LIBOR, the ATO expects that in most cases this is likely to be characterised as a variation of the existing contract rather than the creation of a new legal contract. This would apply, for example, where the parties intend to maintain the existing contract and agree to replace LIBOR with one of the new RFRs. In that case, we would generally expect to also see adjustments[3] to be made to the contract to broadly maintain the substance of the arrangement (and take into account material differences between LIBOR and the relevant RFR).

An amendment to a legal contract should be analysed by both parties by determining the position agreed between the parties to the contract and whether this represents a variation to an existing contract or a rescission of an existing contract and the creation of a new contract.[4] Each party should form a view on the legal effect of the amendments made and have suitable processes in place to evidence the legal view that has been reached for a given contract or a portfolio of contracts with near-identical terms and conditions.

The way the amendment is recorded in an internal system (for example, by cancelling an existing entry and booking a new entry in the system) will not determine the legal effect of the amendment.

Where fallback provisions come into operation according to the existing terms of the original agreement (that is, there is no amendment to an existing legal contract), this should not be regarded as a variation to the contract and therefore in the absence of any other changes it will not be necessary to consider whether a new contract has been created.

You may want to seek professional advice to help you to make an informed decision regarding the legal effect of any amendment you make to your contracts as a result of IBOR reform.

Tax implications where changes only vary the original contract

Where an IBOR amendment results in the variation of the contract, and the contract represents a financial arrangement that is subject to the TOFA regime, there may be an assessable gain or deductible loss for tax purposes depending on the particular TOFA tax-timing methods which apply.

If you have made a TOFA tax-timing method election which relies on the way that a financial arrangement is treated under the accounting standards, such as the reliance on financial reports (ROFR) method or some other relevant elective method, the income tax consequences should largely follow the accounting outcomes.

For example, a spread adjustment or different term structure of the financial arrangement to reflect the new RFR may result in a credit or debit adjustment to the profit and loss of the parties and this may trigger an assessable gain or deductible loss for tax under the TOFA regime.

If you have not elected the ROFR method or any other elective method, you may need to re-assess or re-estimate your loans under the TOFA accruals/realisation method in Subdivision 230-B of the ITAA 1997.

If the relevant financial arrangement is not subject to the TOFA regime, the income tax consequences of a variation to the contract will depend on provisions outside the TOFA regime, such as the ordinary income and deduction provisions (Divisions 6 and 8 of the ITAA 1997) and Division 16E of the *Income Tax Assessment Act 1936* (ITAA 1936).

Tax implications where changes rescind the original contract and create a new one

Where an IBOR amendment to the contract results in all the taxpayer's rights and/or obligations under the relevant financial arrangement ceasing, this will give rise to a balancing adjustment under Subdivision 230-G of the TOFA regime.

If the financial arrangement is not subject to the TOFA rules, you may need to consider the tax implications in sections 26BB and 70B, or Division 16E, of the ITAA 1936, where the financial instrument is a traditional security or qualifying security (which requires consideration of whether there has been a redemption of the security).

Where the impacted financial arrangement is held on capital account, the termination of the original contract may also result in consequences under the capital gains tax rules; for example, CGT event C2.
Tallerman & Co Pty Ltd v Nathan's Merchandise (Vic) Pty Ltd [1957] HCA 10.

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Morris v Baron & Co [1918] AC 1.

2

For example, amendment to the spread or margin or the requirement of additional payments to be made between the parties.

3

We accept that the legal analysis may include consideration of the accounting treatment or analysis of amendments to a contract or contract in a portfolio of contracts with near-identical terms and conditions. However, it will generally not be appropriate to rely solely on the accounting treatment and you should maintain contemporaneous documentation which explains the legal analysis undertaken and the way the accounting treatment was used in the analysis.

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Transfer pricing considerations

The implications for transfer pricing when a cross-border financial arrangement is amended to transition from IBOR.

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Businesses should consider if a transfer pricing benefit may arise when transitioning from LIBOR and other IBORs.

A transfer pricing benefit may arise when a cross-border financial arrangement is amended to transition from IBOR. This will generally be relevant where the parties to the cross-border financial arrangement are related.

In determining whether an amendment might result in a transfer pricing benefit, it will first be necessary to consider whether the amended financial arrangement is consistent with what arm’s length parties would do. Generally, we would expect a low likelihood of a transfer pricing benefit arising from an amendment to transition from IBOR where the amendment is:

- in line with market practice and the most recent recommendations published by the relevant industry and regulatory body including
  - the Alternative Reference Rates Committee, including its Guiding Principles
  - the Working Group on Sterling Risk-Free Reference Rates
  - the Working Group on Euro Risk-Free Reference Rates
  - the National Working Group on Swiss Franc (CHY) Reference Rates
  - the Cross-Industry Committee on Japanese Yen (JPY) Interest Rate Benchmarks
  - the International Swaps and Derivatives Association (ISDA), including the ISDA 2020 IBOR Fallbacks Protocol and the Fallback Supplement to the 2006 ISDA Definitions
  - Bloomberg, including its IBOR Fallback Rate Adjustment Rule Book
  - the Loan Market Association (LMA), including its template terms.

- consistent with the transitioning of your relevant third-party financing arrangements and those of other members of your multinational group, and
- limited to the contractual terms necessary to implement the transition.

You should keep contemporaneous documentation which records and explains the amendments made to your cross-border related-party financing arrangements and why they are consistent with the arm's length principles. This may include support for the commercial rationale and appropriateness of the approach applied and alignment with the factors listed above. Taxation Ruling TR 2014/8 details more information about transfer pricing documentation and Subdivision 284-E.

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Other tax considerations

Tax implications for additional payments and withholding tax exemptions for lending arrangements.

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Key tax considerations of additional payments

The tax impact of additional payments made in response to IBOR reform to maintain existing economic positions will depend on the source and character of the payment. Lending arrangements that are modified solely to respond to IBOR reform will generally continue to receive any withholding tax exemptions they previously received.

In some circumstances, parties may be required to make additional one-off or a series of payments to the counterparty for the purposes of preserving the parties' economic positions where the financial arrangement is amended in response to IBOR reform.

We understand that in the majority of cases, changes to contracts for the purpose of responding to IBOR reform will not result in the need for additional payments as the economics of the transaction between parties will be broadly maintained through the adjustments made to the new RFR.

Where additional payments do arise, the tax impact of the payment/receipt of these payments, regardless of whether there has been a variation or rescission of the existing contract, will depend on the source and character of the payment, which may result in a potential assessable gain or deductible loss for income tax purposes or a withholding tax liability. You should consider the nature of this payment, which will depend on the nature of the underlying contract and the party making the payment.

Where a borrower is required to pay an amount to the lender, we would generally expect this payment to be compensation to the lender for being kept out of the use and enjoyment of the principal sum and therefore be in the nature of interest.[1]

For completeness, where a lender is required to pay an amount to the borrower, we would generally expect that this payment cannot represent compensation to the borrower for being kept out of the use and enjoyment of the principal sum and would not be in the nature of interest.

Impact on the availability of existing withholding tax exemptions

Some lending arrangements impacted by IBOR reform may benefit from an existing concessional treatment for the purposes of withholding tax. For example, the issuer of a debenture may be exempt from the requirement to pay interest withholding tax under the public officer test in section 128F of the ITAA 1936.

Where this is the case, the eligible lending arrangements will continue to receive concessional treatment under section 128F of the ITAA 1936 where the relevant contract amendment due to IBOR transition does not result in the termination and creation of a new financing arrangement. This concessional treatment would extend to any additional payments arising as a result of IBOR reform that are in the nature of interest. We would generally expect this to be the case where a borrower is required to pay an amount to the lender as a result of IBOR reform.

If an arrangement is modified in a manner that results in a new financial arrangement, where amendments are made other than solely for the purpose of responding to IBOR reform, the arrangement may be treated as reissued or a new loan facility and therefore you will need to consider whether any interest payments made after the modifications continue to be exempt from interest withholding tax.

Where an amendment is made to a syndicated facility which has already satisfied the requirements of section 128F of the ITAA 1936, and that amendment is made solely due to IBOR transition, this would not affect the existing concessional treatment under section 128F of the ITAA 1936.
Commissioner of Taxation v Myer Emporium Ltd [1987] HCA 18.

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Responding to IBOR reform – examples

See how the tax implications of IBOR reform will play out in various scenarios.

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Common tax issue examples that may arise as a result of changes made to financial arrangements driven by IBOR.

To illustrate some of the more common tax issues that may arise as a result of changes made to financial arrangements driven by IBOR, the principles discussed in this guide are provided in the examples below, which build upon the following high-level scenario.

Responding to IBOR reform – scenario

In response to IBOR reform, ABC Ltd, an Australian entity subject to the TOFA regime, has made changes to contracts underpinning its financial arrangements which contain references to any IBOR-related benchmark rates (IBOR-impacted arrangements), such as:

- replacing the existing benchmark rate in the relevant agreement with an alternative RFR
- amending existing fallback clauses or introducing fallback clauses where they do not currently exist
- making other incidental variations to contracts as a direct consequence of IBOR reform, such as additional payments or credit spread adjustments to be made for the purposes of preserving the parties' economic positions.

ABC Ltd has undertaken (and is able to demonstrate that it has undertaken) a legal assessment of all changes made to its financial contracts in response to IBOR reform (either on an individual contract basis or a portfolio basis for contracts with near-identical terms and conditions). As a result of this assessment, it has determined that:

- in most circumstances, the changes made to each contract/relevant portfolio for IBOR reform are minor and would be considered a variation to the original contract
- the amendments are intended to ensure that the fair value of the original transaction is substantially equivalent and the economic position of each party is broadly maintained
- in certain circumstances, the changes made to a contract are significant, inconsistent with the original contract and reflect the intention of both parties to rescind the original transaction and create a new contract.

Example 1; contract variations consistent with market standard terms

One of the various IBOR-impacted arrangements identified by ABC Ltd is a four-year GBP floating rate facility provided to XYZ PLC (its UK subsidiary) in 2020. The interest rate for this debt facility is 3M GBP LIBOR + 1%. The existing fallback language in the facility agreement contains a historic standard LMA rate calculation clause which defaults to the last LIBOR screen rate in the event that LIBOR is no longer available. That is, in the absence of any legislative or prudential remedies dealing with legacy contracts, the existing fallback language will change the facility into a fixed-rate facility based on the last published LIBOR rate on 31 December 2021.

In response to IBOR reform, ABC Ltd and XYZ PLC agree to amend the relevant contract by inserting standard LMA provisions relating to the transition from LIBOR to SONIA. The amendments include replacement of the existing LIBOR reference rate with SONIA, as well as the inclusion of industry-accepted fixed credit spread adjustments and a methodology to calculate the compounded SONIA rate. The fair value of the amended facility (at the time of amendment) is substantially equivalent to the original facility (just before the amendment). The changes are consistent with the transitioning of ABC Ltd's similar arrangements with third-party customers.

TOFA consequences

Based on the fact pattern in this example, the ATO considers that the amendment is a variation and does not rescind the original contract. As ABC Ltd is subject to the TOFA regime, there is no balancing adjustment gain or loss for ABC Ltd under Subdivision 230-G of the ITAA 1997. However, there may be an assessable gain or deductible loss for tax depending on the specific rules applicable to ABC Ltd under the TOFA regime.

If the TOFA regime does not apply, the income tax consequences of a contract variation will depend on provisions outside the TOFA regime, such as the ordinary income and deduction provisions (Divisions 6 and 8 of the ITAA 1997) and Division 16E of the ITAA 1936.

Transfer pricing

The changes were considered to be in line with market practice, consistent with the transitioning of ABC Ltd's third-party arrangements and limited to variation of contractual terms necessary to implement the transition. The ATO will generally view the changes as having a low likelihood of resulting in a transfer pricing benefit. ABC Ltd should maintain contemporaneous documentation which records and explains the changes made and compliance with the arm’s length principle.

Example 2: third-party contract amendments consistent with market standard terms

One of the various IBOR-impacted arrangements identified by ABC Ltd is a nine-year cross-currency interest rate swap entered into with its Australian third-party customer DCE Pty Ltd. The cross-currency interest rate swap is used by DCE Pty Ltd to hedge a EUR exposure arising from a EUR-denominated term funding raised offshore.

ABC Ltd and DCE Pty Ltd pay interest rates inclusive of margins based on 3M BBSW and 3M EURIBOR respectively.

In response to IBOR reform, ABC Ltd and DCE Pty Ltd agree to amend the terms of the relevant contract in accordance with the terms of the ISDA 2020 IBOR Fallbacks Protocol relating to the transition from EURIBOR to €STR. The fair value of the amended facility (at the time of amendment) is substantially equivalent to the original facility (just before the amendment).

TOFA consequences

Based on the fact pattern in this example, the ATO considers that the amendment is a variation and does not rescind the original contract. As ABC Ltd is subject to the TOFA regime, there is no balancing adjustment gain or loss for ABC Ltd under Subdivision 230-G of the ITAA 1997. However, there may be an assessable gain or deductible loss for tax depending on the specific rules applicable to ABC Ltd under the TOFA regime.

If the TOFA regime does not apply, the income tax consequences of a contract variation will depend on provisions outside the TOFA regime, such as the ordinary income and deduction provisions (Divisions 6 and 8 of the ITAA 1997) and Division 16E of the ITAA 1936.

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Our commitment to you

We are committed to providing you with accurate, consistent and clear information to help you understand your rights and entitlements and meet your obligations.

If you follow our information and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we will take that into account when determining what action, if any, we should take.

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