1 September 2021

Hector Thompson
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Australian Taxation Office
Goulburn St NSW 2000

Dear Mr Thompson

Tax Implications of IBOR Reform

AFMA, ABA and the FSC appreciate the opportunity to respond to the ATO's Discussion Paper titled "Tax Implications of Inter-bank Offered Rate (IBOR) Reform" (the Discussion Paper).

We have set out below some initial observations on the Discussion Paper to facilitate further engagement with the ATO.

Practical Risk-Based Approach to IBOR Transition

At a high-level, AFMA, ABA and the FSC would support the ATO outlining a practical approach to the taxation consequences on IBOR-transition which leverages existing processes being undertaken by affected taxpayers and categorises the various affected contracts from a risk perspective. This would ensure that compliance resources are appropriately allocated. The approach adopted in PCG 2017/8 regarding internal derivatives would be an appropriate precedent for such an approach.

Practical Reliance on Accounting Treatment

Under the approach outlined in the Discussion Paper, it is necessary for taxpayers to review each contract under which the reference rate has been changed from an IBOR to a different rate to determine whether there has been a legal form variation or rescission of the underlying contract. That is, the approach adopted in the Discussion Paper is that the source of truth for determining the taxation consequences of IBOR reform is the legal effect of the contractual changes.

This approach presents practical difficulties for our members, based on the sheer volume of contracts that did or do reference an IBOR which is to be reformed and hence has been or is to be replaced with an alternate benchmark. The determination as to whether there has been a legal form variation or rescission has not been undertaken and will not need to be undertaken for any other purpose by affected entities. As such, the analysis demanded by the Discussion Paper will be solely for taxation purposes.

Entities that have contracts that have been or will be subject to IBOR reform will be required to make a determination from an accounting perspective as to whether changes are sufficiently material to result in the cessation of the old asset and the creation of a new asset, or merely the continuation of the existing asset. The vast majority of members of AFMA and the ABA have made the TOFA Financial Reports election under Section 230-395 of the 1997 Act and, accordingly, have broad alignment between the taxation and accounting consequences from transactions with respect to financial arrangements, while many fund managers make use of the default accrual approach. Given this, alignment between economic equivalence from an accounting/accrual perspective and continuation of the underlying contract from a tax perspective is efficient and consistent with the policy underpinning the TOFA provisions.

AFMA, ABA and the FSC would support the ATO adopting a risk-based approach where, for TOFA Financial Reports/accrual taxpayers and solely in relation to IBOR-reform, alignment between the accounting/accrual and the taxation consequences could be characterised as "low-risk."

Similarly, contracts with third parties should be, by definition, considered to be low-risk from a taxation perspective. The regulatory approach required to be adopted by AFMA, ABA and FSC members with respect to replacing IBORs in contracts with risk-free rates (RFRs) and including fallback language in the relevant contracts is to ensure fairness with respect to counterparties, and the terms related to replacement rates included in impacted contracts are to be struck on an arm's length basis. Indeed, as required by Australian financial regulators such as the RBA and ASIC, the requirement to replace the IBOR with the RFR with an appropriate credit-spread adjustment on a "fair" basis should mitigate the amount of any transfer of value between the parties.

Scope Limitation to IBOR Changes

In the view of AFMA, ABA and FSC members, the scope of the Discussion Paper, including the examples, should be limited to changes to contracts arising solely from IBOR reform. That is, as articulated in the paper, changes to:

- Replace the existing IBOR benchmark rate in the relevant agreement with an RFR (or other replacement benchmark rate) and align the interest rate calculation and other relevant mechanics to the use of the RFR or other relevant replacement rate;
- Implement market conventions applicable to the RFR or replacement rate into the contract including amending or incorporating fallback clauses (or market disruption provisions) for a temporary or permanent RFR or other IBOR replacement rate unavailability scenario; and
- Make 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.

Where there are additional changes to contracts, such as, per Example 3, changing the terms of a loan contract from a floating rate facility to a fixed rate facility, then such changes are beyond the scope of IBOR reform and will be addressed under the existing law.

Our view is that, where the contractual amendments are of a type set out above (i.e. replace the benchmark rate, insert/amend fallback provisions and preserve economic equivalence) then these should also be categorised as low-risk from a tax perspective and generally not give rise to a balancing adjustment under Division 230, irrespective of the form of the relevant transaction.

Characterisation of Payments

AFMA, ABA and the FSC would like to explore further the statement in the Discussion Paper that a payment from a borrower to a lender as compensation for the change in the underlying reference rate for a contract is an amount of interest, in the nature of interest or in substitution for interest and therefore subject to interest withholding tax (absent the application of Section 128F or another exemption). As noted in the Discussion Paper, in the example of a loan, payments may be required by either the lender or the borrower depending on for the expected cash flows under IBOR compare with the alternative RFR. This would suggest that the payment is not compensation for the use of money, and accordingly not in the nature of interest.

Application of the Public Offer Test

In relation to the continued operation of Section 128F with respect to contracts that are subject to amendment due to IBOR reform, the approach adopted in the Discussion Paper is that where there has been a legal form rescission due to the significance of the amendments, then either the requirements of Section 128F will need to be re-satisfied or the payments of interest under the contract will be subject to interest withholding tax, as the arrangement will be treated as reissued or a new loan facility.

In relation to this point, we note that basis on which the public offer test was initially satisfied is relevant to its continued application, even where there is a new arrangement. For example, under Section 128F(3)(d), the public offer test may be satisfied "as a result of negotiations being initiated publicly in electronic form...used by financial markets for dealing in debentures or debt interests." In our view, even in respect of a new arrangement, where the initial contract resulted from negotiations conducted in satisfaction with this provision, then the public offer test may continue to be satisfied.

We believe that there is scope to confirm the continued application of Section 128F to existing arrangements that have been modified to accommodate IBOR cessation. We consider the analysis is more nuanced than merely a conclusion as to whether the contractual variations are sufficient to result in a new contract. At the very least we would like the ATO to confirm that an amendment to a syndicated facility which has already satisfied the requirements of Section 128F, where that amendment is made to effect the transition from an IBOR to RFRs (assuming no other amendments other than those set out in the "Scope Limitation to IBOR Changes" section above) does not affect the existing IWT treatment. The requested confirmation would provide greater certainty given the material number of transactions that are to be transitioned as a result of IBOR reform, and would avoid a narrow reading or interpretation of Section 128F where this may not be warranted.

Specific Questions from the Discussion Paper

Does the Discussion Paper appropriately reflect industry practice in relation to the most likely changes which have, or will be, made to financial arrangements that are driven by IBOR reform?

To the extent that the Discussion Paper requires a legal analysis of each affected contract to determine whether it results in a legal form variation or rescission, then it does not reflect industry practice.

The examples in the Discussion Paper are predominately based around IBOR-based cash products such as loans. Is AFMA able to provide comment on any additional common

IBOR reform scenarios which would arise in relation to cash products or other financial products such as derivatives?

The focus on IBOR-based cash products is appropriate. Generally speaking most derivatives are Fair Value Through P&L.

Is it practical for industry to determine economic equivalence for each of its financial arrangements transitioning from LIBOR? For example, can industry rely on the 'substantially similar' test used for accounting to make that assessment? If not, how else is industry able to determine whether each of its financial arrangements remain substantially the same post IBOR transition?

As noted above, this analysis is already conducted for accounting purposes, and we would support leveraging the accounting analysis from a tax perspective.

ow will industry determine whether all its contracts that underpin individual financial arrangements remain substantially the same post IBOR transition from a contract law perspective?

There is no requirement for this contract law analysis to be undertaken for any non-tax purpose.

How is industry able to calculate whether IBOR transitioning may result in a change in the value of its related party financial arrangements?

As part of the broader transfer pricing analysis that AFMA, ABA and FSC members undertake.

Are there scenarios where debt and its corresponding hedging derivatives may not result in the post-transition derivative being effective for accounting purposes? E.g. We understand that at first instance on the "Benchmark Replacement" waterfall, the Alternative Reference Rates Committee has recommended a simple instead of compounded Secured Overnight Financing Rate (SOFR) for syndicate loans. We understand however that International Swaps and Derivatives Association compliant derivatives would use a compounded SOFR.

This is possible, depending on the terms of a particular transaction. Generally speaking, however, it is expected that such circumstances are relatively limited and typically controlled via the application of a "floor" to the relevant replacement base rate (being the RFR + any applicable spread adjustment). To the extent such circumstances arise, it will be a matter of the terms of the particular transaction as to whether any such "payment" operates by way of: (i) a set-off against (for example) other amounts owing from the borrower; (ii) a reduction in principal; or (iii) a direct cash payment from the lender.

Are there scenarios where a lender is required to pay an amount to the borrower as compensation for a negative spread adjustment due to the structure of the replacement risk free rate, or is it more likely that the lender would reduce the principal balance owing? What is the typical fact pattern for derivatives that are impacted by negative spread adjustments?

How prevalent, and in what circumstances, are one-off payments likely to be made in lieu of credit spread adjustments as part of the IBOR transition process?

This is not expected to be a common occurrence in respect of cash products.

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Thank you for the opportunity to contribute to the ATO's Discussion Paper. We look forward to engaging further.

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