

GLOBAL CASH MANAGEMENT - INTERNATIONAL TAX ISSUES

I. INTRODUCTION

Multinational corporations are increasingly focused on centralising their banking arrangements and streamlining their bank relationships. Group Treasurers are often given the role of managing the group's cash whether it is located in a group finance vehicle or within subsidiaries' accounts.

II. BACKGROUND

Global cash management is a technique for centralising control of and access to cash balances wherever located around the world, and managing the net cash balance to the overall benefit of the corporate group.

1. Benefits of global cash management

- Increased treasury efficiency.
- Achievement of economies of scale in the treasury function (e.g. by improving the group's overall credit standing through a reduction in its exposure to the banking system, and thereby obtaining the best possible commercial terms for all members' transactions).
- Reduction of banking charges.
- Management of the volatility of a group's liquid cash resources on a daily, monthly or annual basis.
- Maximisation of interest returns/minimisation of interest expense by offsetting cash shortages and surpluses within the pooling system (thus avoid a banking spread).

2. Types of cash management techniques

The term "cash pooling" usually refers to notional pooling and zero balancing techniques (in a wider sense, it may refer to all netting arrangements). These are the two different conceptual techniques applied to cash management at a territory and global/regional level.

In either scheme, the essence of cash pooling is intercompany financing from surplus pool members to deficit pool members, and such intercompany financing under the cash pooling arrangement reduces total interest payments to third parties, i.e., cash out to parties outside of the company group. In addition, under the cash pooling arrangement, in general surplus pool members are able to maintain the current interest income level, or can receive more interest through a cross guarantee between the pool members.

Benefit derived from the reduction of cash out to third parties by way of such a cash pooling arrangement is called “pooling benefit”. Generally, this pooling benefit is allocated among the pool members.

To clarify the concept of pooling benefit, an example is shown below:

	In case of stand alone transaction				Cash pooling	Pooling benefit
	Member A	Member B	Member C	Total	Account balance	
Balance	\$500	\$500	(\$600)	\$400	\$400	
Interest rate	4%	4%	(6%)	-	4%	
Interest	\$20	\$20	(\$36)	\$4	\$16	\$12

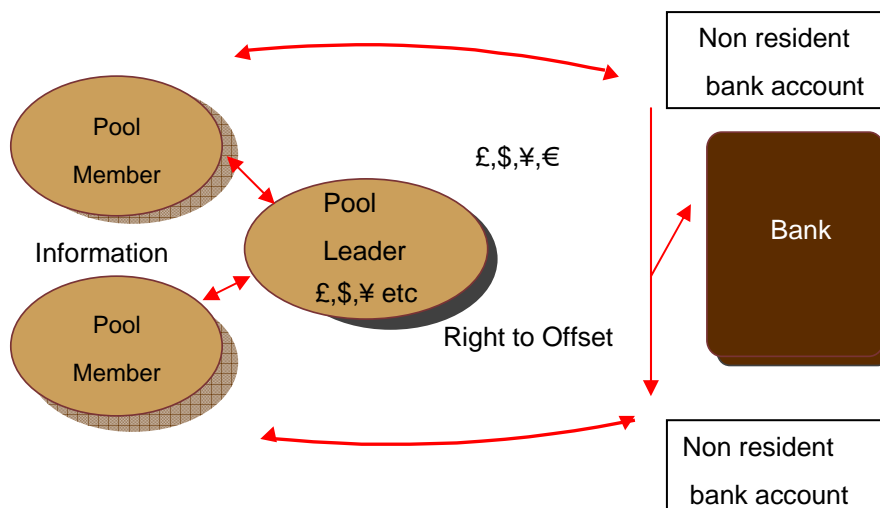
In the above example, the total net amount of bank interest received by each pool member is \$4. However, by offsetting the surplus fund and the deficit fund between the pool members, the interest receivable is increased to \$12. This is the result of offsetting the fund deficit (\$600) by the surplus fund and therefore avoiding bank interest spread of 2% (=6%-4%). The difference is equivalent to the pooling benefit.

Although not included in the above example, a cross guarantee between each pool member in the cash pooling would generally result in an increase in the credit rating as a whole. This is therefore applicable to the favourable bank interest (for example, increased deposit interest and reduced interest payable). Also in this case, an additional pooling benefit is available.

(1) Notional pooling

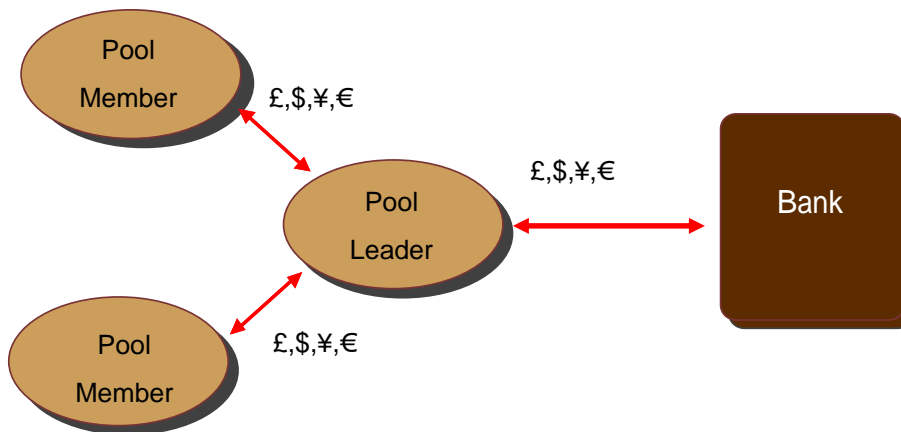
Notional pooling (also referred to simply as pooling) involves the notional set off of cash balances for members of the pooling system. Broadly, it does not involve mixing funds belonging to different legal entities that participate in the pool (although arrangements need to be legally formalised).

The diagram below demonstrates the cash flows:



(2) Zero balancing

Zero balancing (also referred to as cash concentration or sweeping) is where account balances are physically and legally moved on a periodic basis to a central account and/or separate location where all accounts will be mixed, as demonstrated below:



III. INTERNATIONAL TAX ISSUES

The most important and widely encountered tax issues arising from global cash management schemes are discussed below. They can be summarised as:

- Transfer pricing
- Deductibility of interest and thin capitalisation
- Other anti-avoidance rules, including anti-tax haven legislation and GAARs
- Withholding taxes on interest
- Location of the pool leader
- Indirect taxes
- Documentation

1 Transfer pricing

The tax authority in each jurisdiction will typically wish to satisfy itself that charges are made at arm's length and are neither inadequate nor excessive.

The most important aspects that should be considered are:

- Allocation methodology (e.g., margins on the borrowings);
- Comparables (i.e., market practice); and

- Documentation: including board minutes, loan agreements.

The main areas to focus on with regard to transfer pricing are:

- Interest rates between pool members. These should be based on market rates (depending on the currency and terms of the funding). There will be a range of possible borrowing/depositing rates and a mid-point must be found that is acceptable to all parties. In some jurisdictions there may be a benchmark interest rate (+/- base rate) for inter-company loans that tax authorities might seek to apply.
- Allocation of benefits from pooling. As discussed above, numerous benefits arise from cash pooling, and the members of the cash pool are entitled to share in these benefits. Typically, compensation is factored into the pricing of interest margins between the pool members and the pool leader. The absence of any generally recognised Revenue practice could mean that even the most reasonable methodologies will be subject to scrutiny. Generally, and as a minimum, pool members would expect to do slightly better, or at least no worse, under a pooling arrangement than they would on a stand alone basis.
- Guarantee fees. Banks require cash pooling arrangements to include a cross-guarantee between all the members. It may thus be necessary to compensate those members who are taking additional risk. Since those pool members with higher credit ratings are passing on this benefit to other pool members, they should receive an arm's length compensation for this service. Again, market rates should be used in determining the appropriate level of any fee but that market rate is not always easy to quantify.
- Charges for treasury management services. The pool leader will usually provide services to all members, by negotiating preferential interest or transaction rates, the extension of overall credit terms or by managing a reduced number of banking relationships. The cost of running the pool (e.g., management time, set-up fees, bank charges, etc.) needs to be apportioned amongst those benefiting on a basis similar to that which a third party might charge for comparable services. The pool leader's charge can be built into the interest rate, or it could be a separate commission.

2 Deductibility of interest and thin capitalisation

Interest deductibility may be affected by whether it is:

- paid to a bank or a related party;
- paid to another resident of the same state or cross-border;
- settled within a predetermined time (e.g., within one year of becoming due); or
- rolled up or expensed through the profit and loss account.

For notional pooling arrangements, one issue is the nature of the payment from the pool leader to pool members, and whether it still retains its character as bank interest.

Regarding thin capitalisation, interest on loans from an overseas related party will generally only be tax deductible if a company's gearing does not exceed the level specified by a jurisdiction's rules. Restriction of relief may be absolute (i.e., denial of relief for interest on loans exceeding the amount which the authorities believe could have borrowed from a third party lender) or it may be a deferral (i.e., the amount which may be deducted in a particular period is restricted by reference to a factor such as interest cover).

There are obvious thin capitalisation considerations where zero balancing is used, because inter-company loans are put in place. Notional pooling arrangements might be successful in mitigating these rules. However, their advantages can be negated by specific tax rules or by the Revenue authority's views on back-to-back bank loans and the existence of cross-guarantees between the pool members.

Non-deductible interest may also be re-characterised as a distribution for tax purposes, with associated consequences (e.g., withholding tax). In some jurisdictions the principal amount of certain "upstream" loans may also be treated as a distribution.

3 Other anti-avoidance rules, including anti-tax haven legislation

Many jurisdictions have anti-tax haven rules whereby the profits of an offshore group company, which is not believed to be carrying on an active trading business (and is not a holding company for such a trading company), can be taxed concurrently in the parent company's jurisdiction. An offshore treasury company, which is perceived to be acting as a "cash box" company, may fall into this category.

Some territories also have general anti-avoidance provisions. These may affect cross-border activities in particular, including such areas as:

- back-to-back funding arrangements;
- transactions not at arm's length generally; and
- transactions designed to give one of the parties a tax advantage.

Naturally, the level of sophistication and general view of a particular tax authority on the tax issues involved in cash pooling arrangements are of significant practical importance.

4 Withholding taxes on interest

Interest is often liable to taxation at source, especially when it is paid cross-border, and also, though in fewer cases, on a domestic basis. The party paying the interest is typically liable to

deduct and account for tax at the time of payment. Withholding tax requirements and rates should therefore be ascertained before the arrangements are active.

The following factors may influence the requirement to withhold tax in a jurisdiction:

- whether payable to a bank or a related party;
- whether payable on a “resident” or “non-resident” bank account;
- whether paid to another resident of the same State or cross-border;
- availability of double tax treaty protection; and
- whether payable on short or long term loans.

Withholding taxes suffered on interest income may generally be recovered either by:

- refund; or
- offset against tax payable in the recipient jurisdiction.

However, this is not always feasible. To assess whether withholding tax, which cannot otherwise be avoided, is an absolute or simple cash flow cost, it is important to confirm:

- whether tax suffered will be recoverable under one of the above mechanisms;
- the process in each jurisdiction for recouping the tax at the earliest opportunity; and
- the time required for refund procedures or the delay between the due date for payment of withholding tax by the payer and the date when relief is given to the recipient.

The inclusion of “gross-up” clauses (i.e. in the loan agreement, whereby the borrower must pay any tax costs by grossing-up the amount of the interest payment so that the lender receives interest as if there had been no imposition of tax) should be considered when creating loan documentation.

In most jurisdictions it is necessary to obtain clearance from the tax authorities in advance of the first interest payment where withholding tax on interest is exempted or the rate reduced under a double tax treaty. This process may require the provision of documentation and evidence that treaty conditions are met. If the required procedures are not completed and tax is not withheld, interest and penalties may start to accrue.

In some jurisdictions it is also necessary to secure advance clearance for the right to advance a loan, or deposit funds, with an overseas counterparty.

5 Location & status of the pool leader

It is possible to influence the tax effects noted above by judicious choice of the location of the pool leader. If the pool leader is located in a jurisdiction which has a good network of double tax treaties, then the cross border implications are likely to be minimised.

In Asia, Singapore has the advantage over Hong Kong of a wide treaty network, although Hong Kong has a lower rate of company taxation.

The relationship between the pool leader and participating pool members should be clear; in particular as to whether the pool leader acts as principal or agent in the netting arrangements. If the pool leader's activities are not properly operated, they may exceptionally create a taxable permanent establishment in another jurisdiction. Although the opening of a bank account by a non-resident should not on its own create a taxable presence, non-resident pool leaders may stretch this view if they do more than simply banking their surplus deposits, such as entering into treasury management functions.

6 Indirect taxes

Consumption (including VAT) taxes

For consumption tax purposes, some aspects of funding activities are not zero-rated but actually exempt: such transactions need to be taken into account in considering a company's recovery rate and can have a bearing on its partial exemption calculation and hence its ability to recover consumption tax.

Stamp duties

The configuration of bank accounts and the sweeping of funds to/from accounts in certain jurisdictions may increase the incidence of stamp duties on certain loans (usually on the turnover of the debit or credit transfer).

7 Documentation

Documentation requirements are becoming increasingly onerous. Support may need to be provided:

- in respect of clearance applications to the tax or other regulatory authorities;
- to evidence transfer pricing arrangements in respect of interest margins, guarantee arrangements, and management services; and
- in connection with thin capitalisation or other provisions which might limit the deductibility of interest on transactions between related parties.

The required documentation includes transfer pricing support (e.g, functional analysis, comparative analysis, board minutes and allocation methodology) plus service level agreements and standard loan/facility agreements.

8 Issues to consider when conducting cash management by Japanese companies

(1) Background

In cases of cash management by Japanese companies, pool leaders are usually foreign companies that are located in European countries, on taking into account the tax treaty network (tax treaties concluded with pool member countries) and corporate tax rates, etc.

However, in the case of most Japanese companies, a part or all of the actual management activities, system development, operation of surplus fund, decision making procedures, etc., are conducted by Japanese parent companies. In such a case, the following issues should be noted:

- Permanent establishment (PE) risk of the pool leader if it is a foreign company, for Japanese tax purposes
- Remuneration for the provision of services by the Japanese parent company
- Japanese tax treatment of the Japanese branch of the pool leader if it is a foreign company

(2) PE risk of the pool leader in Japan

If it is regarded that a foreign company pool leader has no real substance, and it is therefore deemed that the Japanese parent company conducts the daily operation activities and decision making procedures, the Japanese tax authorities might classify the Japanese parent company as a PE in Japan for the foreign company pool leader. In such a case, regarding income from the spread of loans receivable and payable among the pool members, pooling benefits and surplus fund management profits, the income attributable to the PE in Japan should be reported in the Japanese tax return. In order to avoid such a PE risk, it is important that the pool leader has enough substance and carries out activities itself. However, if all of the actual operation activities and decision making procedures cannot be conducted in the country of the pool leader, a service provision agreement should be concluded between the pool leader and the Japanese parent company, under which the activities conducted by the Japanese parent are clearly limited as much as possible, and the Japanese parent should receive proper remuneration for these limited services. Alternatively, a Japanese branch of the pool leader should be established in Japan, and the said branch should conduct the limited activities and file the Japanese corporate tax return.

(3) Remuneration for the provision of services

If a part of the cash pooling activities, activities when negotiating with banks, or any other necessary tasks, is conducted by the Japanese parent, the said Japanese parent should receive the proper remuneration for the provision of services for transfer pricing taxation purposes.

(4) Tax issues to note when the pool leader establishes a Japanese branch

If the pool leader establishes a Japanese branch, and borrowing and lending activities are conducted through the said branch, the following issues should be considered in particular:

Interest receivable:

When the foreign company pool leader has a Japanese branch and loans abroad through the said branch, the interest receivable from overseas borrowers is treated as a domestic source income and thus is subject to Japanese tax. However, if this interest receivable is subject to foreign taxes, including withholding tax, it may be excluded from taxable income. Consequently, if the foreign company pool leader agrees a loan to a pool member located in a country where no withholding tax is imposed, for example Hong Kong, interest receivable on such a loan should be included in the taxable income of the Japanese branch.

Interest payable to be borne by the Japanese branch:

When the foreign company pool leader has a Japanese branch, and this Japanese branch operates borrowing and lending businesses, the interest payable to the surplus pool member is regarded as interest to be borne by the Japanese branch, and thus is subject to Japanese withholding tax. Therefore, in this case, the surplus pool member who will receive the interest should consider not only a tax treaty with the pool leader's home country but also a tax treaty with Japan with regard to its foreign tax implications on the interest.

Therefore, in the case of cash management by Japanese companies whereby the Japanese parent company conducts a part of the management, the issues stated above must be carefully considered in order to determine the structure, in addition to the other international taxation issues as stated in 1.-7. above.

IV. CONCLUSION

This article has identified the tax risks that are often considered too late, after structures have been painstakingly established by a partner bank or advisors with inadequate experience of the underlying commercial realities and precise legal obligations involved.

The majority of the tax exposures highlighted can be alleviated with careful planning and structuring.

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For further information, please contact Yasuko Takahashi or Mayumi Nakamura at:

E-mail: pwcjapan.taxpr@jp.pwc.com Tel:03-5251-2400