Transfer pricing issues related to cash pooling

21 Jun 2016 at 04:00

As cash pooling gains more favour among businesses, it needs to be considered from the perspective of both the lender and the borrower to minimise tax risk. It also raises transfer pricing issues, notably the determination of arm's length interest rates and the allocation of pooling benefits between the pool leader and participants.

Cash pooling is a cash management technique that many multinational enterprises have adopted to utilise excess cash more efficiently and reduce overall funding costs by minimising the interest paid to banks from a group perspective.

This article looks at physical pooling to demonstrate transfer pricing issues. Under this arrangement, the pool participants' accounts are swept automatically into the pool leader's account. The pool leader will then enter into intercompany loans with participants having a cash surplus or deficit.

The Thai Revenue Code and the Thailand Transfer Pricing Guidelines require that the interest rate on such loans must not be lower than the market rate unless there are "justifiable grounds"; otherwise revenue officers would have the power to assess additional tax.

The guidelines define "market rate" as the interest that independent contracting parties determine in good faith and charge in a commercial manner for the same type of loan at the same time as the transaction in question. In third-party dealings, various factors must be considered in determining rates, including the borrower's creditworthiness, term to maturity, currency and collateral.

Nonetheless, the Revenue Department has issued rulings providing guidance on "justifiable" interest rates in related-party loans. These are:

where the amount of the loan is derived from the lender's own funds, the interest rate must not be less than that of a fixed deposit with a commercial bank; and where the amount of the loan is derived from a loan from another source, the interest rate charged must not be less than the rate paid to that source.

Note that justifiable interest rates from the department's viewpoint depend only on the source of funds. In addition, the rulings focus only on the rate charged by the lender. There's no guidance on what happens if the rate is deemed unacceptable from the borrower's perspective. This could lead to a potential tax risk of non-deductibility for the borrower.

For instance, let's say a pool leader borrows from the bank at 6% for further lending to a pool participant at 6.5%. The leader could in fact charge 6% and still be in compliance with Revenue Department rulings. However, the rulings do not address whether a rate of 6.5% from the borrower's perspective would be acceptable to the department. A borrower seeking to deduct the additional interest expense would have to demonstrate reasons and prepare supporting documents to show that the additional 0.5% was not excessive.

Note also that Revenue Department rulings are interpretations of the law and apply in practice as a "safe harbour". Since they do not supersede tax laws, questions could arise about whether the interest rate could fall outside the safe harbour if a reliable benchmarking study of intercompany loans existed to prove that the interest rates are at the market level.

Another concern is the allocation of pooling benefits, which is the difference between the interest paid/received on the net cash pool balance and the amount of interest paid/received if all participants had deposited with, or borrowed from, commercial banks.

Under the cash pooling arrangement, there are at least three parties involved: the pool leader, a participant who has a cash surplus and another with a cash deficit. To determine a fair share of pooling benefits among these parties, a proper functional analysis -- functions performed, risks assumed and capital employed -- needs to be performed.

The participant who deposits cash to the pool should be remunerated with a higher interest rate in order to encourage it to participate. Similarly, the participant who needs to borrow from the pool would enjoy a lower rate as it also commits to contribute capital to the pool whenever it has a surplus.

The pool leader could be viewed as performing more functions and assuming more risks when compared with the participants if it acts like a bank in providing credit to group companies. In this regard, the leader needs to manage the surplus cash of the group by matching deposits and loans efficiently to minimise its costs. For instance, if all participants have surplus positions, the pool leader would bear the costs as it could not utilise the surplus in an efficient manner.

Furthermore, the leader must also hold sufficient capital to support its positions and the line of credit it provides, as well as assume the credit risk of the participants from the pool bank. As such, it would demand a higher share of the pool benefit than the pool participants. However, if the leader merely provides administrative services, it should be remunerated based only on its routine contribution.

In summary, it is crucial for an enterprise to consider the functions, assets and risks of all relevant entities, as well as the guidance from Revenue Department rulings, in determining interest rates in order to minimise its transfer pricing risks.

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