DEFEATING THE OBJECT

TOM ROSS OF BFINANCE LOOKS AT THE PROBLEMS FACING FIRMS WHEN THEY SET UP EURO CASH POOLS AND FIND OUT HOW THE REGULATIONS ACROSS EUROPE ARE HAMPERING THEIR EURO POOLING PROGRESS.

In January's issue of *The Treasurer*, Brian Welch suggested that fewer companies have implemented euro cash pooling than their banks would have us believe. In this article, we look at the underlying factors in an attempt to find out why more companies are not getting involved in euro cash pooling.

FIRST PRINCIPLES. The key objectives of 'cash concentration' techniques – for example, physical sweeping, notional pooling or a hybrid scheme – are: to enhance the balance sheet by offsetting surplus funds against overdrafts, thereby reducing gross debt shown on the balance sheet; to minimise interest payable and bank charges, and/or to maximise interest receivable.

'Notional pooling' is the technique whereby debit and credit balances within the scheme are notionally offset without the physical movement of funds between accounts. Sweeping or zero-balancing occurs when funds are physically cleared (or zero-balanced) from operating accounts and transferred into a single treasury account. Generally, notional pooling is considered the best route. There are no inter-company loans and no fees for cross-border transfers, although difficult to achieve.

The euro removed only one of the barriers to pooling. If your balances are denominated in several currencies, pooling them into one account requires translation into a base currency. But if all your business units operate in a single currency, this part of the process is eliminated. The euro has, of course, had a wider impact. Banks across Europe recognised its launch as the signal for intensified competition for clients, and euro pooling was a vital part of their armoury. Less cynically, banks worked harder to make euro cash pooling a reality. So what happened? Put simply, Europe has not yet changed that much, as the following illustrates.

LEGAL RIGHT OF SET-OFF. For a bank to report a pool as a single net balance, it must have legally recognised access to all pool balances in the event that one of the members runs into financial difficulties. Where legal opinions as to the effectiveness of set-off cannot be obtained or are inconclusive, this potentially leaves the bank without recourse should one company within the pooling arrangement default. Therefore, in the absence of confirmation of legal right of set-off covering the whole pool, Bank of England regulations require that banks put up capital in support of its assets, thus adding to bank charges and reducing the benefits of the pooling. Even where the client group is prepared to meet the bank's increased costs, the bank provider's credit limit policies may preclude the institution from taking on exposure to group companies for whom the right off of set-off is unclear.

Most notional pools are set up in the UK, where the legal right to offset balances is accepted by the Bank of England for business units within a single legal entity. For pool members located in other countries, that legal right has to be established locally. In jurisdictions where a satisfactory legal opinion is difficult or impossible to obtain (the insolvency laws of several countries have come under scrutiny), the client's bank may, for the reasons outlined above, decline to include certain business units in a pooling arrangement, resulting in incomplete pooling. At the very least, the cost of obtaining independent legal opinions across a range of jurisdictions can be prohibitive.

CROSS GUARANTEES. A cross guarantee is a confirmation that each pool member agrees to cover the liability of the other pool members. *The FSA Prudential Sourcebook for Banks* (Vol II, Other: NE Collateral and Netting, 7.4) permits that this guarantee should extend only to the credit balances held (so that other group companies are not liable for other group company debts unrelated to the pooling arrangement). As the cross-guarantee provision is intended to create mutuality of debt in a pooling arrangement, where all accounts in a pool are already 'joint and several' liabilities of all group members, no further cross-guarantees are needed.

ALLOCATION OF INTEREST/POOL 'BENEFIT' TO THE CLIENT. The allocation of interest/pool benefit may, in some cases, be subject to challenge by the local tax authorities, particularly when funds are moved away from high-tax jurisdictions. Generally, the pool leader must be seen to allocate interest to borrowers and lenders within the pool on an arm's length basis – that is, within 'reasonable' commercial boundaries so that the taxable base in any territory cannot be regarded as artificially reduced.

The pooling benefit (the difference between the interest accounts would have paid/received separately and that earned within a pool) can be allocated either to one single entity or allocated back into the different operating units in the pool. To comply with local tax transfer pricing requirements, pool members should pay and receive interest at the normal commercial rate but after that it is up to the firm to decide how to allocate the pooling interest. According to banks, a number of firms have opted for a sweeping/zero-balancing over notional pooling, as there is no end-of-day balance on which interest/tax can be charged.

LOCAL CONSIDERATIONS. So-called pan-European institutions may still need to rely on correspondent banks to complete their branch network, potentially compromising the efficiency of pooling arrangements. In addition, even where a bank's branches are located in the relevant countries, the staffing and infrastructure in these offices may not be able to deliver the same standard of service as the bank's representations in major centres. While there are no rules against multi-bank pooling, problems can arise when this results in a reduction in income for smaller banking partners.

Another factor is that operating units may have sound operational reasons for insisting on continuing use of long-term local banking partners, for example, for payroll or collections purposes. Overlay structures can channel funds from local accounts but are likely to add to implementation costs. Operating units are often reluctant to implement further software to pass funds up to the overlay bank, but recent advances in 'thin client' technologies are easing such concerns.

'MOST COMPANIES SET UP A HYBRID ARRANGEMENT THAT INCORPORATES PHYSICAL SWEEPING AND NOTIONAL POOLING'

WITHHOLDING TAXES ON INTEREST/INTERCOMPANY LOANS. Before any firm sets up a cash pool, it should get independent tax advice. Banks typically indemnify themselves against a pooling structure being ruled illegal or as constituting a tax liability. Some countries withhold tax at source on payments of interest on intercompany loans created by cash concentration. Intercompany loans are more visible with sweeps, but notional pools can also be regarded as creating them. Although it may be possible to reduce the rate of withholding under tax treaties, there are administrative hurdles to overcome. At best, withholding tax suffered represents a cashflow disadvantage. At worst, it is permanently irrecoverable.

In a notional pool, it is often unclear who is lending to whom. If two participants in a three-member pool are in credit, and the other is in deficit, their local tax authorities may decide that both surpluses are funding the overdraft. Reference accounts, which have common ownership but each account is used only by an individual member of the pool, can avoid this problem, but the tax authorities are likely to pay close attention to all structures that create inter-company loans. If cash is being concentrated into a header account through a zero-balancing arrangement, inter-company loans are still being created, but it is much clearer who is lending to whom.

OTHER TAX ISSUES. Although none of these issues are major barriers to pooling structures, it is worth flagging a few issues for consideration. The tax treatment differs from country to country and the rules are changing all the time.

- **Deductibility of interest.** In some jurisdictions, local legislation may restrict or preclude the deductibility of interest on loans from another group company. This is because some countries do not recognise borrowing from non-bank lenders and others have specific provisions relating to connected party transactions.
- **Thin capitalisation.** In addition to local deductibility issues, even where an interest deduction in a jurisdiction would generally be allowed, pooling arrangements may fall foul of anti-avoidance legislation covering instances of 'thin capitalisation'. Thin capitalisation rules are designed to prevent a group from financing their subsidiary's operations with an insufficient ratio of equity capital to debt capital. The tax authorities argue that where this occurs, the amount of taxable profit in the jurisdiction where the 'thinly capitalised' subsidiary is located is artificially reduced, as the amount of interest deduction claimed covers too great a portion of income. Therefore, the tax authorities may disallow deductibility of interest or require an injection of equity capital into the subsidiary business. Interest and penalties may also apply in some countries.
- **Transfer pricing.** Where cash pooling involves inter-company loans, the terms on which services are provided will be scrutinised. Similarly, if the amount of interest charged is not at arm's length, part of it could be treated as not tax deductible.
- **VAT.** It is easy to overlook the VAT implications of transactions between EU counterparties. 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 VAT recovery rate and can have a bearing on a partial exemption calculation.
- **Stamp duty.** Some countries impose stamp duty on intercompany loans, so potentially reducing the overall pooling benefit.
- **Taxable presence.** Revenue authorities in different countries are likely to take varying views on whether a treasury acting on behalf of an overseas subsidiary should be regarded having established a taxable presence.

RESIDENT AND NON-RESIDENT ACCOUNTS. A number of EU member states apply different rules to accounts held by companies that are legally resident, than to accounts held by non-resident firms. This can make notional pooling impractical or not economically viable in cases such as France, where interest cannot be earned on both types of account. It is possible to get around resident/non-resident problems perhaps by setting up a permanent taxable presence in the country in question or by zero-balancing funds to the UK and pooling from there.

MORE EFFORT THAN IT'S WORTH. It is less correct to say that notional pooling is not possible in certain EU states than to assert that legal and fiscal regulations make implementation of a pooling structure more effort than the benefit accrued is worth. Rather than prohibiting notional pooling, local regulations often make the situation unclear, resulting in operating units in some countries not participating in the pool. Most companies set up a hybrid arrangement that incorporates physical sweeping and notional pooling but, due to different legal and tax situations, it is unlikely that a structure that suits one firm will also meet the needs of contemporaries. As the Association's training material on international cash management states: "Cash pooling is 90% due diligence, 10% systems."

Tom Ross is Managing Director of bfinance.co.uk.
tross@bfinance.com
bfinance.co.uk