OPPORTUNITY OR THREAT?

IS THE EU PURELY ADDING TO THE REGULATORY BURDEN THAT TREASURERS FACE OR IS THERE SOME GOOD NEWS DRIVEN BY FURTHER HARMONISATION? **LEON CANE** AND **SHAWN MCCARTHY** OF KPMG EXPLORE A FEW TOPICAL ISSUES.

In the wake of the imminent adoption of the International Accounting Standards (IAS), most corporate treasurers would intuitively consider European Union (EU) regulations to be a further external constraint which will make their lives difficult and could potentially render their existing tax and treasury structures ineffective. However, some recent tax rulings are definitely a mixture of good and bad news.

This article looks briefly at the impact of International Accounting Standards before exploring some recent European tax rulings.

INTERNATIONAL ACCOUNTING STANDARDS. Most treasury practitioners will associate the EU with the main reasons for the drive towards IAS. The most important regulatory issue in the treasury arena is the requirement to adopt IAS 39.

The European Commission has proposed that all EU listed companies be required to prepare their consolidated financial accounts using IAS by 2005. Companies will also have to provide comparative figures for 2004, in practice this means that the closing 2003 position must be stated.

IAS 39 has already attracted much attention in the UK since it will bring an array of new rules partly based on the American accounting standard FAS 133. In the wake of Enron and the other recent accounting scandals, many have commented that such a methodology could be difficult to reconcile with the "true and fair view" approach of the existing UK accounting standards and most treasurers are now trying to get a firm grasp of the issues.

RECENT TAX RULINGS. IAS will undoubtedly affect the majority of treasury teams in the EU. For many corporates with activities in Europe there are also a range of tax rulings that did not hit the headlines in a similar fashion to IAS, but that could also have a very significant impact on the effectiveness of existing treasury structures.

These changes are driven by the willingness of the EU to achieve a degree of harmonisation and attack the 'exception regimes'. So far this has meant that consistent tax rules within a member state are acceptable but 'exception basis' tax rules need to change or disappear. This logic means for instance that the new relatively low corporation tax rate of 12.5% in Ireland will not be challenged by the EU, but that the special status granted to the Belgian co-ordination centres needs to be adapted. As a result however, the Inland Revenue is due to remove Ireland from the list of Controlled Foreign Company (CFC) exception countries.

■ KEY REQUIREMENTS OF IAS 39

- All financial assets and financial liabilities are recognised on the balance sheet, including derivatives;
- all financial assets and liabilities must be categorised into the following captions: held for trading; loans and receivables originated by the enterprise and held-to-maturity investments, available-for-sale financial assets;
- changes in fair value of derivatives to be recognised in the income statement, except when hedge criteria are satisfied; and
- special accounting treatment is provided for the change in value of derivatives designated and qualifying as: fair value hedge; and cashflow hedge.

Also relevant to the treasurers will be:

- IAS 32 *Financial Instruments: Disclosure and Presentation;* and
- IAS 21 *The Effect of Changes in Foreign Exchange Rates*.

Some of the issues which will potentially affect two of the most popular locations for treasury or finance centres, namely Belgium and Ireland, are set out below.

BELGIUM. Multinational corporations are already trying to deal with the threat to their Belgian co-ordination centres.

It is clear that the Belgian co-ordination centre structure is under attack from the European Commission. Co-ordination centres operate under licence, with the status granted under royal decree for a period of 10 years, which can be extended. The centres are not taxed on their actual commercial income, but on a notional amount, calculated on the basis of a mark up on some operating costs and expenses. Crucially, the cost base has excluded major cost components such as employment costs.

The key benefit for treasuries is that the interest income of the centres, where capital is lent to related companies at market rates of interest, is disregarded for tax purposes. A centre can therefore lend its share capital, retained earnings and other equity-type elements to group companies and charge arm's length interest without being taxed on this income.

The centres have proved popular, and there are currently more than 200 such centres operating in Belgium.

FIGURE 1
AVAILABILITY OF STAFF (IN KPMG'S EXPERIENCE).

	HIGH Fully staffed in four months	MEDIUM Fully staffed in four to six months	LOW Fully staffed in more than six months
Amsterdam		✓	
Brussels		✓	
Dublin		✓	
London	✓		
Luxembourg			
Switzerland		Geneva ✓	Basel/Zurich ✓

Because of the preferential tax regime, the centres are now subject to two different EU challenges. Firstly, the centres are said to infringe the EU Code of Conduct on harmful tax competition. Secondly, the Belgian regime is regarded as incompatible with EU rules of State Aid.

The EU has proposed that the co-ordination centre regime be abolished by 2005. There would still be 111 valid licenses by this date. The Belgian government would prefer to see out the 10 year term of these centres.

Despite recent efforts by the Belgian government to tighten the rules, the centres are unlikely to survive – especially in light of the formal State Aid investigation launched by the EU in February.

Alternative and longer term treasury planning by many multinationals will be needed to replace these centres.

IRELAND. If your treasury centre is located in Ireland rather than Belgium, you still don't escape regulatory change.

The Inland Revenue announced on 23 July 2002 that Ireland is to be removed from the list of CFC excluded countries. This means that Irish-resident companies will no longer be able to qualify for exemption from the CFC legislation under the excluded countries regulations.

The reason given for this change is that the progressive reduction in the rate of Irish corporation tax (currently 16% which will be reduced to 12.5% from 1 January 2003) means that it is no longer possible to readily distinguish between Irish CFCs which have been established there for genuine commercial, as opposed to tax, reasons.

The EU proposes to make the necessary changes by laying regulations before Parliament on 20 September 2002. The changes will apply to accounting periods of Irish CFCs beginning on or after 11 October 2002.

The introduction of the changes has been delayed in order to allow interested parties to make comments to the Inland Revenue. The proposed change means that Irish CFCs (including captives) will not, in future, be able to qualify under the excluded countries regulations.

Ireland is commonly used as a location for group finance and treasury activities and where the companies involved rely upon the excluded countries regulations, the structures will no longer be effective.

The drive towards harmonisation could, however, also bring some opportunities on the treasury tax front as 'inconsistencies' between tax rules of the various member states are challenged. We explore a few of those emerging topics in turn.

EUROPEAN UNION LAW AND CONTROLLED FOREIGN COMPANIES. A number of countries have rules which tax profits of CFCs where these profits are not remitted to the parent but retained overseas.

The Fédération des Experts Comptables Européens (FEE) has recently noted that the variations of the CFC legislation between the Member States means that a legal challenge in the European Court of Justice (ECJ) seems inevitable.

The majority of Member States have CFC legislation. Austria, Greece, Luxembourg, Ireland and the Netherlands do not have a CFC regime, although domestic rules in these countries can achieve the same apportionment and thus local taxation of profits.

Where countries do have CFC rules, they have also adopted different methods for attributing, taxing and exempting CFC income. For example, France and Germany apply CFC rules to companies located in countries where the tax rate is less than a certain percentage of the domestic tax rate. The UK exempts CFCs in countries where the tax rate is above a certain percentage of the UK tax rate. Italy leaves the specific percentages out of their legislation, and has a blacklist of locations to which CFC rules will always be applied.

Member States may be in violation of the EC Treaty or other EU laws if resident taxpayers are treated differently depending on the residence of their subsidiaries. Parent companies may also have legitimate discrimination claims against their state if their subsidiaries are subject to different CFC rules as a result of different tax treaties between the parent's state of residence and that of the subsidiary.

INTERCOMPANY DEBTS AND THIN CAPITALISATION RULES. Most OECD countries now have 'thin capitalisation' rules. These rules limit the level of debt for which a company can obtain interest relief when borrowing from a connected party. The level of debt is compared to the equity and where the 'gearing' is considered excessive, interest deductions can be denied. The excessive amount is reclassified as a non tax deductible dividend.

The rules in EU Member States are not uniform. A recent German case could however dramatically change the position across the EU Member States. The *Lankhorst-Hohorst* case is concerned with the payment of interest by a German company to its Dutch parent. The interest was reclassified as a non tax deductible distribution under German thin capitalisation rules. Had the loan been from a German rather than a Dutch shareholder, the German distribution treatment would not have applied. *Lankhorst* argues that the German rules are therefore contrary to the freedom of establishment. The oral hearing at the ECJ was in May 2002, and the ECJ's decision is likely to be due sometime in 2003 or early 2004. A favourable decision could eventually lead to the abolition of thin capitalisation rules within the EU.

There is no guarantee that, even if the tax payer wins in *Lankhorst*, loans from the US, Switzerland or Australia to a Member State via a company resident in another Member State would benefit (although depending on which countries are involved, it may be possible to invoke the anti-discrimination article of the relevant tax treaty). However, there may be limited downside and considerable upside in routing loans.

Loans could be channelled via a EU finance company in, for example, Luxembourg or the Netherlands. This would probably involve a margin being taxed in the country used. There is no withholding tax on interest paid out of either Luxembourg or the

Netherlands, although the thin capitalisation rules in the country of residence of the finance company would need to be considered in respect of capitalisation from outside the EU (having regard to any possible non-discrimination arguments, as noted above).

AND WHAT CAN THE FUTURE HOLD? The EU continues to talk about removing tax obstacles which hinder trade. In particular, the EU is keen to promote its vision of a common consolidated tax base. This would allow the income of an entire group to be computed according to one set of rules and establish EU -wide consolidated accounts for tax purposes.

While the grand EU vision may seem distant, changes are being made with increasing pace. One example is the EU's Joint Forum on Transfer Pricing. This forum is likely to put added pressure on states such as Ireland which do not, as yet, have transfer pricing rules. Treasurers who have relied on Irish financing structures may need to re-think their medium to long term strategy.

THE END OF TREASURY CENTRES IN THE EU? The answer is not that straightforward, mainly for two reasons. First, the ideal treasury location will be unique to each company. Depending on the location of their various operating companies and the main objective of the treasury centre (financing company, in-house bank, etc), it may be necessary for certain companies to operate within the eurozone or the EU. There is still a very wide array of tax rules and corporation tax rates within the Union which certainly leaves scope for efficient tax planning.

Second, many corporate treasurers will also need to take into account some very significant non-tax issues such as office space, IT infrastructure, availability of staff and local employment regulations.

The difficulties in setting up new treasury centres should not be underestimated. In a recent survey of potential treasury locations in Europe, we found that the traditional locations in the eurozone, such as Ireland, the Netherlands and Belgium generally scored well in terms of availability and quality of staff, accessibility and cost of maintaining offices.

Countries such as Switzerland may benefit from more flexibility than its counterparts in the EU and the potential regulatory threats may seem less likely. It is, however, obviously important to adopt a combined tax and treasury approach since, depending on the objectives, certain Swiss locations might not score as strongly on general treasury management issues and it can prove more difficult to establish a large treasury team there.

To conclude this review of EU driven tax and treasury regulations, it can be inferred that planning is of paramount importance. By keeping informed and planning ahead, corporate treasurers should be able to avoid unpleasant surprises and adapt to the new regulatory environment.

Loving or loathing the EU and its implications, one thing appears certain, not many treasurers are able to adopt a head-in-the-sand attitude as no doubt many more changes will appear soon.

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PROFILE

PETER GRAHAM
GROUP TREASURER
NESTLÉ UK

AGE	35	
EDUCATION & QUALIFICATIONS	Queen's College Taunton (1978-82), KCS Wimbledon (1982-84)	
	1991	University of Portsmouth, BA Hons. Economics
	1995	ACMA
	2000	ACT
CAREER HISTORY	1989	Graduate Management Trainee, Rhone Poulenc
	1991	Management Accountant, Rhone Poulenc
	1993	Treasury Accountant, Rhone Poulenc
	1995	Treasury Operations Manager, SmithKline Beecham
	1997	Treasurer, Dyson
	2001	Assistant Treasurer, Nestlé UK
	2002	Group Treasurer, Nestlé UK

"I must admit, when I started working, I didn't even know that treasury was a career option. After falling into accounting initially, I soon discovered I could do something involving numbers that was actually quite interesting. Having expressed an interest in the department, an opportunity arose shortly afterwards and I snapped it up.

"I started in eager anticipation of becoming an incredibly well-paid wheeler-dealer, parading the office, using language incomprehensible to all but the select few who were 'in the know', revered by colleagues as a 'treasurer'. In reality, I had to restart my career from the bottom rung, commit to yet another set of exams and I don't think people really thought I sounded cool when I told them that "cable had fallen out of bed".

"Since then, I have had the fortune to get my grounding in one of the leading UK treasury departments, started a function from scratch in one of the UK's fastest growing companies in the 1990s, and am currently participating in the centralisation of European treasury activity in the world's biggest food company. Although my initial expectations of what a career in treasury meant may have been a bit misguided, I certainly have no regrets and am still very happy to be able to say that I really do enjoy my job."