MORE THAN THE SUM OF THE PARTS

AN EFFECTIVE RELATIONSHIP BETWEEN THE TREASURY AND TAX FUNCTIONS CAN ADD REAL BUSINESS VALUE. **CHARLES TOMKINS** OF BT LOOKS AT WHERE TAX IS MOSTLY LIKELY TO HAVE AN IMPACT ON TREASURY.

At the simplest level, tax involves cash going out of a business and, as the person with a firm hold of the business's purse, this makes tax important to the treasurer. Unfortunately, tax has a reputation of being incomprehensible – the preserve of a few with impaired communication skills. Yet the treasurer does not need to be a tax technical wizard to contribute to the management of tax-related cashflows and risks. This article aims to arm the treasurer with a practical approach to tax management and with an understanding of 'the right questions to ask' of his tax adviser.

THE TAX FUNCTION. The corporate tax advisory role can be fulfilled either by an in-house tax function or externally. The first objective of the tax adviser is legitimately to minimise the cost of tax to the company. Secondary objectives include managing the tax charge in the accounts, which has a direct impact on earnings per share and managing tax risks to ensure that the finance director is not faced with any unpleasant surprises.

The tax adviser will look to achieve these aims by running or advising on the tax compliance, which is the process of complying with tax law, ensuring accurate and complete tax returns are made and that tax payments are made on time. Additionally, the tax adviser should have procedures in place to ensure that company's day-to-day business is tax efficient and that one-off transactions are brought to the tax adviser's attention in advance to allow tax advice to be given. This reciprocal process should include both the tax function advising treasury of anticipated cash impacts of taxation and the treasury function seeking advice on funding and other treasury transactions. Both functions should also ensure that they share information received from other business areas on activities which may impact on the company's financial or risk position.

TAX AND THE TREASURER. In short, the relationship between the tax adviser and the treasurer is key in ensuring that the flow of information on tax-related issues within the company is timely and complete and that tax risks are effectively managed. The following section looks at some of the areas where the treasurer should be aware of the potential tax impacts on the treasury function.

CASH MANAGEMENT

CASHFLOW FORECAST. The treasurer should ask the tax adviser to ensure that all known tax payments are included in the cashflow forecast. All taxes for the business should be included, the most likely are corporate tax, PAYE and VAT. Corporate tax is a tax on the company's profits. PAYE is withheld on wage payments to employees and additionally includes the cost of employer's National Insurance. With VAT the company acts as an unpaid tax collector. Customers pay VAT to the company, which the company in turn passes on to Customs & Excise, which administers VAT. The company can recover some of the VAT it pays to its suppliers from Customs. The treasurer should ask the tax adviser if VAT cashflow is being maximised and whether VAT recovery is optimal.

Sight of an up-to-date cashflow forecast is also invaluable to the tax adviser as it allows significant transactions to be identified and tax advice given in advance. Unfortunately, it is difficult to give tax advice once a transaction has already occurred.

TAX PAYMENT. Once the tax adviser has identified the payments for the cash forecast, he or she should be encouraged to provide the funds flow form for tax payment in good time. The tax payment will legally need to arrive with the tax authority on a particular date. Normally, late payment of tax will give rise to interest, which is often not tax deductible and at a poor rate. Fines and penalties for late payment are also possible.

The value date given by the tax authority for payment should be checked with the tax adviser. Often electronic payment is encouraged by value dating the day before payment is made. Cheques deposited at the tax office by hand are often given value when delivered to the tax authority, which may then take some days to cash the cheque. However given the risks of paying late if there is uncertainty a careful approach should be taken.

INTERNATIONAL FUNDING

The tax adviser should be asked two questions about any new interest payments, particularly when one party to the loan is outside the UK.

WITHHOLDING TAXES. First, is it acceptable to pay the interest gross? Countries like to impose withholding tax on payments made out of their countries (that is, of the full payment of 100, 10 is paid to the local tax authority and 90 is paid to the payee). This is popular as the tax is then paid by persons who do not vote in the country. It is not so popular with the person administering the withholding or the payee. The payments usually affected are cross-border interest, royalties and dividends. A country's local law will set down the rate of withholding. This may be reduced by the tax treaty between the payer and payee's countries. It may be necessary to apply either in advance or retrospectively for the treaty rate.

The loan documentation should be reviewed to see if there is a need to 'gross up' interest payments. A gross up is where the payer bears the cost of the withholding tax so that the payee is made good and receives a net amount equivalent to the gross. In the above example, instead of the payer making a total payment of 100 (90 to the payee and 10 to the tax authorities), the payer would pay out 111.11, transferring the full 100 of interest to the payee and paying over 11.11 to the taxman. Such arrangements obviously increase interest costs to the payer and may affect the overall viability of funding arrangements.

INTEREST DEDUCTIBILITY. The second question to ask the tax adviser is to confirm that the interest is deductible for the purposes of corporation tax. If it is not tax deductible then the post-tax cost of borrowing will be high. This may occur if the debt is advanced by a group company on non-commercial terms, for example, the interest rate may be excessive or the amount of debt advanced may be higher than the amount a bank would advance, given the amount of equity or interest cover. The above is referred to as 'thin capitalisation'. Occasionally interest may also not be deductible due to specific provisions in local tax legislation. For example, in some jurisdictions, interest paid on loans to finance capital projects or share buybacks cannot be deducted.

Another area to watch is the timing of the interest deduction. If the company is loss-making then there are no profits against which to offset the interest and the tax deduction is likely to occur in the future when profits become available. In the UK, interest is tax deductible, as it is charged to the accounts with one notable exception. Interest paid more than 12 months after the year end to a foreign company is tax deductible when it is paid.

ADDITIONAL OVERSEAS ASPECTS. In addition to these basic considerations, there are also some more sophisticated but essential tax elements to be considered. The treasurer should be generally aware of these, but should make a point of seeking specific tax advice on their detailed application.

TRANSFER PRICING. Transfer pricing is generally recognised as the number one tax issue facing multinational companies today. Most countries' tax laws require that when dealing with overseas group companies the transactions are on reasonable terms, the same as between two unconnected parties. This is known as the 'arm's length' basis. Not only do the transactions need to be on an arm's length basis, but they need to documented at the time they happen and evidence held to prove that this is the case. It is a large task to document all intercompany transactions and difficult to prove they were arm's length. The reason that this is such a large issue is that it affects the amount of profit that a company makes. The US was first country to apply transfer pricing rules rigorously – companies unable to justify their cross-border intra-group pricing were (and still are) assessed to tax on the increased profit calculated by the tax authority on their view of an arm's length basis. This assessment may stretch back many years. There is no guarantee the other countries involved will reduce the profit they tax, which leads to double taxation of the same profit. This lead's groups to consider putting profit in the US to avoid transfer pricing enquiries. However to counter this risk most countries now have aggressively enforced transfer pricing rules to ensure that their tax take is not reduced.

The treasurer's role is to ensure that loan agreements are drawn up for cross-border group loans on normal commercial terms. Second, the treasurer should have the tax adviser sign off on all cross-border inter-company payments, or at least identify unusual payments.

TREASURY CONSENT. The UK tax rules require certain transactions to have clearance from HM Treasury before they take place. Failure to get this permission is a criminal act, which is serious. In practice, no one has ever gone to jail for failing to get treasury consent, but the Inland Revenue will use the failure as a weapon in negotiations with the tax payer. The transactions that the tax advisers view should be asked on include any controlled overseas group company becoming party to a loan or issuing/transferring any of its shares.

MATCHING ELECTIONS. Where a UK company invests in an overseas company and funds the investment with foreign currency debt to hedge the investment then there is a mismatch on the tax on the foreign exchange movements. The movements on the loan are taxed as per the accounts, but the movements on the investment are only taxed when the investment is sold. This means that there is not a hedge on a post tax basis. Accordingly, UK tax law lets a matching election be made soon this will be automatic if certain conditions are met. This means that the movements on the loan are also not recognised until the investment is sold. The tax adviser can advise on the conditions.

OTHER TAX ASPECTS

PROJECT EVALUATION. A further area where the treasurer needs to take account of tax impacts is in the project appraisal process. It is important to treat tax consistently when computing expected cashflows and cost of capital for discounted cashflow methodologies such as net present value (NPV) calculations. As a preference, project appraisal should be done on a post-tax basis and including tax cashflows. Alternatively, the tax cashflows can be left out and a post-tax discount rate used. The tax adviser should be able to check the assumptions used as to tax rate and timing of the liability.

A PROBLEM HALVED... There are, of course, many other areas of taxation that are of interest to the treasurer, for example, those that arise on M&A deals. But an awareness of the above issues should provide a solid foundation for a good working relationship between the treasurer and his or her tax adviser. The tax and treasury functions share the objectives of reducing a company's cost of doing business and of mitigating the risks to which it is exposed. They should also share information and expertise.

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