INCREASING THE SWEEP STAKES

NOW EUROPOOLING HAS BECOME MORE COMMON, EXTERNAL TAX ADVICE ISN'T ALWAYS NECESSARY. BUT **CHARLES TOMKINS** OF BT GROUP BELIEVES IT DOES PROVIDE EXTRA PEACE OF MIND.

The first part of this article, Finding the Right Solution, in October's *The Treasurer,* looked at BT Group's progress in developing, selecting and implementing a successful euro cash management system. This second part explores the practical tax issues encountered and their solutions. As the project gathered momentum it became known internally as 'The Europooling Project' or just Europooling, as I have used here.

The BT tax and treasury departments work closely with each other day to day and this project was no exception. Having tax input from the outset of the project was helpful, not because the tax issues are particularly complex, but rather because it provided time for the workings of cash pooling to be understood by the tax adviser. Also, the naïve question from a non-treasury specialist can be useful when looking at the detail of how these arrangements work. Up-front tax involvement ensured that the banks were only asked to tender with solutions that were likely to work from a tax perspective.

One of the greatest difficulties for a tax adviser is getting to grips with the terminology involved – bankers have a way of dressing up the simple until it becomes complex. However, once that obstacle was overcome, for the BT Group solution, the problem in tax terms was reduced to dealing with cross-border inter-company loans. The main tax issues to be addressed were then transfer pricing and withholding tax.

The BT solution was examined in detail in the first part of this article, but, to recap, it involved primarily one-way sweeping of excess funds from the overseas subsidiaries to the UK. To keep the application of this article broad, I have also included the tax issues for two-way sweeping – that is, where the overseas subsidiaries are funded from the UK.

PHYSICAL CASH SWEEPING OPTIONS. The options included notional pooling and the use of a European Economic Interest Grouping (EEIG), both of which initially appeared appealing for tax but in the final analysis were not chosen by BT Group. Notional pooling does not involve the physical cash sweeping (that is, movement) and the creation of inter-company loans of the sweeping approach. Instead, the balances of the relevant accounts are notionally pooled and a net interest charged or credited to the master account. This appears at first sight to be an elegant solution, possibly reducing withholding tax issues and avoiding the risks of moving money between accounts. However, despite the attractions, from a tax perspective, you would want to feel comfortable as to the treatment of the allocated interest. For example, it would be unfortunate for the pool leader to reallocate some interest received to subsidiary companies, only to find that the pool leader was taxed on the full amount of interest it received and the reallocation ignored. It is also not possible for some countries to participate in a pooling arrangement, which may lead to a hybrid pooling and sweeping solution.

The EEIG solution marketed by a number of banks uses an EEIG, a form of tax transparent European company. Each pool participant owns a stake of the EEIG, and can place funds into the EEIG or borrow from it. This is attractive from a group company buy-in point of view, as they are not having a structure imposed on them by head office. Instead, pool participant's own a part of the cash management entity. However, EEIG's are not particularly well-known and, as such, would need careful due diligence before use.

BT GROUP SOLUTION. The BT solution consisted of the main overseas trading groups setting up local bank accounts which then swept up into the master account held in the UK by the pool leader, its main UK trading company. It was considered there was no benefit in setting up a separate UK treasury firm to run the Europooling. The tax issues to be addressed were transfer pricing and withholding tax.

TRANSFER PRICING. This is a topic that continues to be a *bête noire* for tax professionals working in multi-national groups, because countries ensure that their tax base is not eroded by the three-pronged attack of:

- tax rules that demand transactions with overseas group firms to be on an arm's length basis and contemporaneously documented;
- self-assessment systems that encourage companies to get it right on their own, with large penalties for failure; and
- teams of high-quality specialist tax inspectors to check everything is in order.

Most developed countries' tax laws require loans between group firms that own one another, or are under common control, to be on similar terms to a third-party arrangement, documented and evidence held to justify the third-party nature of the terms. An exception is Ireland, which continues to have no transfer pricing rules, relying instead on a low tax rate to protect the Irish tax base.

COST BENEFITS. The interest rate of the loans is key. The cost benefit analysis in the early planning stages will show the overall financial benefits. The benefits are likely to principally derive from cash concentration, giving better interest rates on deposited money, improved cash forecasting and management, and also by eliminating the bank's margin between deposited and borrowed funds. The costs in terms of bank charges and the additional cost of staff to manage the process should also be, however, incorporated into any analysis.

The basic principle should be that all group firms included in the Europooling arrangement should be better off as a result. This is most easily achieved by giving the overseas subsidiaries better rates for borrowing and depositing than they could obtain locally, while retaining some benefit of the arrangement in the UK. While, theoretically, you could argue that, as the project is driven from the UK, all the benefit should be taken in the UK, it would make the arrangement both difficult to sell to local management and problematic, time-consuming and costly to agree with overseas tax authorities.

The selection of interest rates will bring into question the policy of what rates are used generally for inter-company loans. Again, theoretically, these should be set taking into account solid principles such as currency, terms and credit risk of the loan. In reality, the pragmatic approach is to set the inter-company interest rates using the group's usual method and then to revisit the cost benefit analysis. If it is shown that, with these interest rates, the subsidiaries are not better off (with some benefit left in the UK) then it would suggest there is something wrong with the group's normal method of setting interest rates – time to call in a transfer pricing specialist.

A final area of choice for transfer pricing is the decision as to whether to levy charges beyond the interest. This is likely to be driven off the group's standing practice. If central treasury is currently recharged to subsidiaries, this arrangement should continue. However, the implication on the cost/benefit for each group company should again be considered.

WITHHOLDING TAX. Withholding tax can apply to payments of interest, particularly those cross-border. However, the rates of withholding that apply under domestic legislation are often reduced to nil under the terms of the relevant double tax treaty. There is currently no Europe-wide system of nil withholding tax on interest to mirror the Parent Subsidiary Directive, which allows dividends to pass up to European parent companies without withholding where there is more than a 25% relationship.

The UK withholding tax rules are typically arcane, requiring withholding on annual interest. The UK rules have been softened to allow nil withholding for payments to UK banks and also recently other UK companies.

This has disposed of the need for the Group Income Election and reporting of such payments. However, the UK rules are still in force for payments of annual interest cross-border. Where a loan is capable of lasting more than 12 months then the interest on the loan will be annual interest. Therefore, to ensure interest is not annual you can make the loan for a period of less than a year, say, 50 weeks, and repay the loan for a period and then re-advance a new loan.

The UK's tax treaties with its European neighbours typically reduce the withholding tax rate on interest down to nil – one notable exception being the treaty with Spain, where the rate is 12%. Given the one-way nature of BT's pooling, treaty applications were made. The UK Inland Revenue is familiar with cash pooling arrangements now and it is unlikely that you will have to go into as much detail when reporting to the international division as you might have a few years ago.

The Revenue is not especially keen on upstream loans to the UK and will require assurance that the cash pooling scheme is genuine and not just a route to make large upstream loans. Accordingly, to

> 'THE INTEREST RATE OF THE LOANS IS KEY. THE COST BENEFIT ANALYSIS IN THE EARLY PLANNING STAGES WILL SHOW THE OVERALL FINANCIAL BENEFITS'

keep this in check, the Revenue is likely to give clearance to pay interest with the treaty rate applying, subject to the loan not exceeding certain amounts. For Spain, we decided to shut the cash pooling arrangement down for two weeks each year to ensure the Spanish intercompany loan was kept short.

The application for treaty clearance still takes a number of months and needs to be managed to ensure it does not drag on. The position for cross-border royalties has changed now and there is no need to apply for treaty clearance if you believe that the treaty rate should apply. Unfortunately, there is no such relaxation for interest. It is understood that companies engaged in two-way cash pooling may be able to get the Inland Revenue to agree that the interest remains short.

OTHER TAX ISSUES. The stamp duty and capital duty position on loans need to be checked – in the rare countries where this is an issue, there are usually solutions to any problems

The thin capitalisation position of the overseas subsidiaries needs to be examined closely. This is a transfer pricing related issue, in that tax authorities do not like companies to be funded by debt from related parties beyond the level a third-party bank would be willing to contemplate. Over-funding with debt allows profits to be drained out of a company/country in a tax-efficient manner because interest is generally tax deductible.

Treasury consent is typically required for a two-way pooling arrangement because, although specific treasury consent is not generally required for loans to and from the UK, the two-way cash pooling falls foul of the 'anti-back to back' provisions in the general consent rules. However, HM Treasury is usually happy to issue an evergreen consent, with the stipulation that the balance on the intercompany loan should be reported every six months.

Given that euro cash pooling is now a well-trodden path, the requirement for an external tax adviser for support may no longer be as appropriate as it was a few years ago. However, we took the view that external assurance on a fixed fee basis was useful.

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