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Look before you leap

Executive summary

- In times of recession and credit crunch, cash pooling becomes of major importance, but the practice only pays if a group can avoid the legal and tax pitfalls of a cash pooling structure. Especially in cross-border cash pooling structures, the legal and tax implications must be properly considered.

THE SHORTAGE OF CREDIT MAKES CASH POOLING A KEY TOOL FOR A BUSINESS GROUP. BUT UNLESS THE TAX AND LEGAL IMPLICATIONS ARE CORRECTLY APPRECIATED AND HANDLED, A COMPANY MAY FIND ITSELF EMBROILED IN COSTLY DISPUTES WITH REGULATORS AND TAX AUTHORITIES, AS **JÖRG SCHWERDTFEGER** AND **MAXI WILKOWSKI** EXPLAIN.

There are two forms of cash pooling: zero balancing (also referred to as physical pooling) and notional pooling (also called virtual pooling or margin compensation). Zero balancing is the much more common structure. A business group that engages in zero balancing withdraws all credit account balances from the accounts of the cash pool members and transfers them to a master account from which, in the same step, funds will be transferred to those members' accounts that are in debit. As a result, due to the usual interest spread, the overall group's interest earnings increase – or the interest cost decreases if, after the pooling procedure, the group is still in an overall debit position.

Often, cash pooling occurs at more than one level: there is local pooling on a national level in one jurisdiction, and cross-border cash pooling on a second level. The cross-border cash pool involves a master account held by an ultimate parent entity (such as a holding company or financing company) or an entity set up for that purpose. There are numerous variations of these structures using notional pooling.

THE LEGAL ISSUES The legal framework will usually consist of an agreement with a bank that sets out the service and credit conditions, and an inter-company agreement that sets out the duties and legal relations of the cash pool members. In the case of zero balancing, the flow of funds leads to inter-company loan situations, raising questions about regulatory, company and group law.

The granting of money loans in a commercially organised way qualifies in European jurisdictions as a lending business, which usually requires a banking licence. The acceptance of funds from the

SINCE EACH CASH POOL MEMBER WITH A BANK ACCOUNT IN A CREDIT POSITION (BEFORE THE POOLING) IS GRANTING A LOAN, THE REGULATORY PERSPECTIVE HAS TO BE ANALYSED IN EACH JURISDICTION, AND NOT MERELY IN THE JURISDICTION WHERE THE MASTER ACCOUNT IS LOCATED.

public also requires a licence, since it is seen as a deposit business. However, local banking laws usually provide for a so-called group privilege, which means that intra-group loans and deposits do not trigger a licence requirement and are not regulated by financial services authorities.

Still, before setting up a cash pool it is important to consider whether the members of the pool qualify as a group according to each jurisdiction that is involved. In some jurisdictions the relation fulfilling the group requirement is determined by participation in shares (that is, the voting rights). Since each cash pool member with a bank account in a credit position (before the pooling) is granting a loan, the regulatory perspective has to be analysed in each jurisdiction, and not merely in the jurisdiction where the master account is located.

Cash pooling has a far-reaching effect on the liquidity of an enterprise, and clarification must be sought at an early stage on whether the people involved have the authority to implement a cash pool, or if a shareholders' meeting or the consent of a supervisory board is required. In practice, a detailed plan displaying all the mandatory decisions and documentation can prove useful.

In several jurisdictions, company law protects a company's creditors because the shareholders' liability is limited to their shareholding. Capital maintenance requirements also often prevent the transfer of capital back to the shareholders/parent entity (the cash pooling master company) without an equivalent remaining with the company.

Under German law, for example, there is a general prohibition on the repayment of assets to shareholders unless there is either a subordination or transfer agreement or a full-value equivalent granted in return (here, the intra-group loan could be regarded as a repayment of assets). The German federal court has recently ruled that full value does not mean fully secured and that the creditworthiness at the moment of the payment would be relevant.

The detail of the group structure can also make a difference. Under German group law, for example, there are looser limits where there is a subordination agreement between the parent entity and the member company. However, it has to be shown that the payments are of use for the parent entity or other group companies and the liquidity outflow on the whole must not be detrimental.

In various jurisdictions, management is obliged not to carry out any actions that could put the existence of the company at risk. A cash management system that leads to an uncontrolled outflow of liquidity – for example, due to the insolvency of one of the cash pooling members – could embody such a risk. Any breach of the obligation to care for the company's existence could ultimately result in damages being awarded against the company.

RISK MANAGEMENT It is advisable to implement an early warning system together with the cash pooling system. The purpose of the early warning system is to inform members about liquidity and other financial risks within the cash pool and give them the possibility of reacting accordingly. The information provided within such a system could be regular financial statements of the members involved, economic ratios or at least an obligatory notice to the other cash

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pool members if the ratios of the members involved reach a critical point. This gives the other cash pool members the possibility of leaving the cash pool and avoiding further losses.

As a consequence, termination rights with a reasonable notice period should be fixed in the cash pooling agreement. The same is true for the information rights. With reference to the intra-group agreement, the other terms of that agreement should be basically at arm's length.

Risks for the cash pool member's existence may not only arise from cash pooling but also from the guarantee often required of all members by the credit institution running the cash pool. Adequate termination rights as well as information duties are highly advisable for this guarantee. The termination rights should be fixed within the guarantee document and the information rights should be fixed within the inter-company agreement.

THE TAXATION ISSUES Taxation becomes relevant in several ways when setting up a cash pool. Interest payments, for example, may be subject to withholding tax. Thin capitalisation and transfer pricing issues may also arise. When it comes to the location of a master account, the different corporate interest rates and incentives or special additional taxes in several jurisdictions should be considered.

Because the business group's funds are pooled, bank interest will only arise on a master account. Accordingly, it is sensible to choose a jurisdiction, such as the UK or Ireland, which has withholding tax exemptions. In Germany, for example, a rate of 26.375% applies for bank interest paid to resident companies, whereas in Luxembourg such payments are withholding tax-exempt.

However, to keep in line with the arm's length principle, the loans granted by pool members will have to be remunerated, leading to inter-company interest payment. Within the EU, cash pooling benefits from the EU's Interest and Royalties Directive, which eliminates tax on interest payments when the recipient is a resident company of another EU member state and is related to the payer via a 25% participation. Most European jurisdictions also have exemptions for non-bank inter-company payments and for payments to companies resident in a country with a double-tax treaty.

Since the company holding the master account may generate interest income, the corporation tax rate of the location may be important. The 28% rate in the UK is comparable to that in Germany, where there are different rates according to the city of residence that typically range between 26% and 32%. Ireland and Switzerland have a low corporation tax rate, but France levies 33% and imposes extra corporate taxes such as payroll tax.

NOTIONAL POOLING SEEMS A WAY TO AVOID THIN-CAPITALISATION ISSUES, SINCE THERE IS NO ACTUAL FLOW OF FUNDS BUT ONLY A MODIFICATION OF THE INTEREST RATES ON GROUNDS OF THE CONSOLIDATED BANK DEBTS AND CREDITS. HOWEVER, IT HAS TO BE VERIFIED IN WHAT WAY CROSS GUARANTIES WOULD BE TREATED BY THE FINANCIAL AUTHORITIES.

DEBT FINANCING As explained earlier, cash pooling leads to group loan situations that can raise questions about the consequences of debt financing. Most European countries limit the deductibility of interest expenses resulting from these loans, or qualify them as dividends. National tax legislators take different approaches.

In the Netherlands, for example, thin-capitalisation rules apply with a debt equity ratio of 3:1. Non-deductibility will also apply if the transaction is regarded as tainted in the light of the anti-erosion rules or if the interest of the loan is substantially lower than an arm's length interest rate.

Luxembourg has no thin-capitalisation rules, but in practice the tax administration uses a debt/equity ratio of 85:15 for holding companies as an indicator for an arm's length situation.

In Germany, bank interest and interest payments within the group are tax-deductible within the limits of the rules set by the so called interest barrier regulation which replaced the former thin-capitalisation rule. Basically, interest expenses can only be deducted up to 30% of the taxable EBITDA.

Looking at interest rates and documentation from a tax perspective, it should be noted that in most European jurisdictions the arm's length principle has to be followed. The effects of double tax treaties and VAT implications should also be examined.

Notional pooling seems a way to avoid thin-capitalisation issues, since there is no actual flow of funds but only a modification of the interest rates on grounds of the consolidated bank debts and credits. However, it has to be verified in what way cross-guarantees would be treated by the financial authorities. Sometimes a cross-guarantee for a bank debt of a related entity ("back-to-back-financing") will also be regarded as debt financing.

Some jurisdictions try to attract potential master account holders. Ireland, for example, has a 12.5% tax rate on the income of a cash pool leader that manages a master account in Ireland. Other jurisdictions also seek to attract treasury operations.

CASH POOL KEYS Setting up a cash pooling system raises legal issues, especially regarding banking regulatory law, company law and group law. From a tax perspective, issues such as withholding tax, thin capitalisation, tax rates, incentives and transfer pricing have to be addressed.

Participation in cash pooling has a tremendous impact on the companies involved, so a detailed plan including the implementation of an early warning system on the cash pooling members' financial situation is advisable. Due to the differing tax environments – which exist even within the EU – the tax consequences should be scrutinised at a local level. This examination should be conducted with the support of a local adviser familiar with the tax and legal legislation as well as the national authority's practice.

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