While the commercial drivers for establishing a group-wide cash pooling system are evident and do not really need to be expounded here, the numerous local and cross-border transactions involved can generate complex tax issues that must be addressed when designing, implementing and operating such a system. In the following paragraphs we look at the main issues that should be considered.

COST/BENEFIT ANALYSIS. For a group considering a cash pooling structure, a cost/benefit analysis is an important initial exercise to assess the level of benefit that could be expected. The decrease in the funding cost for the group may be considerable, but matched against this will be, among other things, the opportunity cost of the internal resource required for implementation and maintenance, advisers’ and legal costs, together with any bank charges if a bank-led structure is adopted.

It will also be necessary to consider whether these costs of implementation are likely to be tax deductible in the pool leader’s jurisdiction. Where this is the UK, there is certainly an argument that all costs should be deductible, but key issues are likely to be whether any cost falls within the loan relationship provisions, whether apportionment is required (on the basis that one or more overseas companies benefit from the scheme), whether the costs fulfil the ‘wholly and exclusively’ test to be treated as a deductible trading expenses, and whether the costs can be considered as revenue items, given that the scheme should have an enduring benefit for the company/group.

POOL STRUCTURE. Assuming that the cost/benefit analysis is persuasive, the next issue will be the choice of structure. Traditionally, there have been two principal forms of pooling structure: zero balancing (ZB) and notional pooling (NP), both of which generate their own tax issues. For example, the physical cash movement of interest payments in ZB can attract withholding taxes in some jurisdictions (for example, on payments from Belgium to the UK), which could represent an absolute cost, rather than a timing mismatch to the group if credit is not available in full (where the withholding tax exceeds the mainstream corporate tax rate in the recipient’s jurisdiction) or is not utilisable (where there are losses). NP may avoid this particular problem, but it can present its own issues, such as the legal complexities that mean this method is not a viable option in all jurisdictions, such as in France.

The most appropriate solution may be a hybrid structure, tailored to fit the group. For example, if the physical pooling of balances is a priority, the structure could be set up so that most participants take part in a ZB arrangement. But where withholding tax is an issue, the balances of those affected participants could be notionally pooled to the pool leader’s account.

It must also be decided as to whether a bank-led solution is appropriate, or whether it might be more flexible or cheaper to implement a structure in-house, particularly where a group has an established and relatively sophisticated treasury function. This decision is primarily a commercial one, but the transfer pricing position might need to be more robust where a third-party bank is not involved, since comparatives may not be readily available for the share of benefit awarded to participants and the reward to the pool leader. Clearly, the establishment of an in-house structure would also need to take place within the legal/regulatory framework of the jurisdiction involved.

LOCATION OF THE POOL LEADER. The overall structure may depend on the location of the pool leader. The primary factor in this selection tends to be the current location of the head office and/or treasury function, together with any distinctive features of the existing company structure. Tax issues may be of secondary consideration, unless there is a clear ‘deal breaker’, such as prohibitively high withholding tax.

The most common locations for cash pooling leaders have tended to be the UK and the Netherlands. Both regions benefit from extensive treaty networks and often (perhaps due to these same treaty networks together with favourable tax regimes) host the group’s head office and/or treasury centre. Belgium may also be a contender, as the beneficial Belgian Co-ordination Centre (BCC) status has been revived. However, it is not clear how long the regime will last – in January 2003, the Ecofin council decided to allow the BCC as one of five preferential tax schemes permitted until 2010 as part of a compromise deal on the taxation of EU citizens’ savings, but the European Commission is taking the council to the European Court of Justice (ECJ) on this point, which it regards as “illegal”.

COLIN COPELAND AND CHLOE JOHN OF ERNST & YOUNG LLP HELP OVERCOME THE TAX HURDLES WHEN SETTING UP A CASH POOLING SYSTEM.
BY-COUNTRY TAX REVIEW. Some high-level tax analysis will probably have been necessary to select the pooling structure and the location of the pool leader. A full review of the tax, as well as legal and regulatory, issues for each relevant jurisdiction is also recommended. There is currently significant variation in the tax analysis for cash pooling even within the EU, but certain key themes tend to recur; we explore them below.

- Withholding tax
As outlined above, withholding tax on interest payments (under ZB) is likely to be a key consideration. The domestic rate may be reduced or eliminated by a treaty, but there are likely to be administrative hurdles to clear to achieve this, which could take time.

- Transfer pricing
Most countries have some form of regulation over the pricing of inter-group transactions, and tax authorities may impute income where they perceive that an arm’s-length pricing methodology has not been used. For cash pooling, the basic principle should be that all participants benefit from participation, and that the pool leader is adequately rewarded for its part in the management of the scheme. For NP, it will be important to establish exactly how the participants are to receive their share of the benefit, and the tax treatment of this payment will also need to be considered.

The associated documentation requirements can be arduous, and it may be necessary to produce third-party comparatives to support the rates used. The UK rules currently apply only to cross-border transactions, but the tax authorities have recently responded to a potential EU discrimination challenge by proposing to extend the scope to all inter-group transactions.

- Thin capitalisation
A related issue is thin capitalisation – a tax deduction for debt financing payments may be restricted where the level of gearing is beyond that which might be expected if group borrowings were instead with third-party banks. As with cross-border transfer pricing rules, existing thin capitalisation regimes may be open to EU challenge, especially following the outcome of the Lankhorst case (Lankhorst-Hohorst GmbH v Finanzamt Steinfurt (Case C-324/00)) in which the ECJ determined that the application of thin capitalisation rules to interest paid by a German company to its Dutch parent ran contrary to the EU treaty. However, moves are being made in certain jurisdictions such as the UK and Germany to counteract the effect of this judgment.

- Stamp duty and other capital taxes
Significant capital taxes do not tend to apply to cash pooling arrangements, although it will still be necessary to check in relation to each relevant jurisdiction. For example, in Italy there are various duties payable on opening a current account and periodic statements, and a fixed registration tax on loan agreements. The quantum of tax payable is likely to be low in most cases, but there may be associated administrative requirements to fulfil. Advance planning is important; for example, French stamp duty should not be an issue provided the documentation for the arrangement is signed outside France.

- Foreign exchange issues
For pools involving mixed currencies, the taxation of foreign exchange (FX) credits and debits in each jurisdiction is worth considering. A number of countries have reporting requirements for cross-border transactions above a de minimis threshold, as in Belgium.

TERMINOLOGY

- Zero/target balancing or cash concentration
Cross-border sweeps to/from a pool leader account reducing/increasing the participant account to zero/a predetermined target balance. These transactions take place on intercompany account.

- Notional pooling
Pooling is achieved by treating separate accounts held by different group entities as one. No inter-entity transfer of cash takes place (but cash may be moved between accounts of the same entity); for example, to an account within the pool leader’s jurisdiction. Interest payments are calculated based on notional balances.

- VAT
In many countries, the granting, negotiation and management of credit are activities that are exempt from VAT; so the implementation of a cash pooling structure should not present incremental VAT issues. However, it will still be important to review the impact such an exempt supply has on each company’s overall VAT recoverability.

- Intercompany agreements
Clarity between the groups involved in the structure will be vital for tax purposes, in terms of who is paying what to whom, and how it is calculated (particularly for transfer pricing support). In addition to any documentation supplied by the bank (if one is involved) for the relationship between it and the pool leader/participants, internal documentation is recommended. For ZB, this should govern the establishment and maintenance of the intercompany accounts. For NP, this should set out formally on what basis participants are to be rewarded.

KEEPING UP TO DATE. For most cash pooling structures, the tax impact of any domestic transactions will be minimal, and even the analysis for the cross-border transactions is unlikely to be technically complex. The key to the structure will be planning. Provided a robust structure is selected in the first instance, the primary tax issues tend to centre around ensuring compliance with (often extensive) administrative and reporting requirements. It is also vital to keep up to date, although for EU pools the continuing intervention of the ECJ may well smooth out current inconsistencies around the region over time.

For structures extending beyond the EU, your advisers may be able to keep you informed about developments relevant to cash pooling, but it is still advisable to review your structure on a regular basis to ensure it remains tax efficient and compliant for all of the jurisdictions involved.

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