Towards Nirvana

DEBORAH ANTHONY, PETER MURPHY AND **IAN HENDRIE** EXAMINE HOW MULTINATIONAL DANA CORPORATION HAS TACKLED THE KEY ISSUES IN TODAY'S CASH ENVIRONMENT.

Executive summary

- The euro and the internet have been key drivers changing the cash environment.
- After in-country cash pooling, many multinationals are now examining centralised payments.
- Centralised payments reduced Dana's bank charges by 30%.
- Tax is a major consideration for both cash pooling and centralised payments.

The last few years have seen a changing face of the treasury function. Key areas have been the arrival and introduction of the euro, the passing of the Millennium Bug and the development and introduction of web-based techniques. These changes have all played a part in the movement of treasury towards shared centres and in-house banking structures.

As part of the evolution or development of the cash environment, corporate treasury will undertake the examination and possible implementation of a number of stages. The overall trend, however, is towards treasury gaining more reliable information, which will in turn facilitate greater control as treasury centres move through in-country and euro pooling towards global pooling and a centralised payments facility.

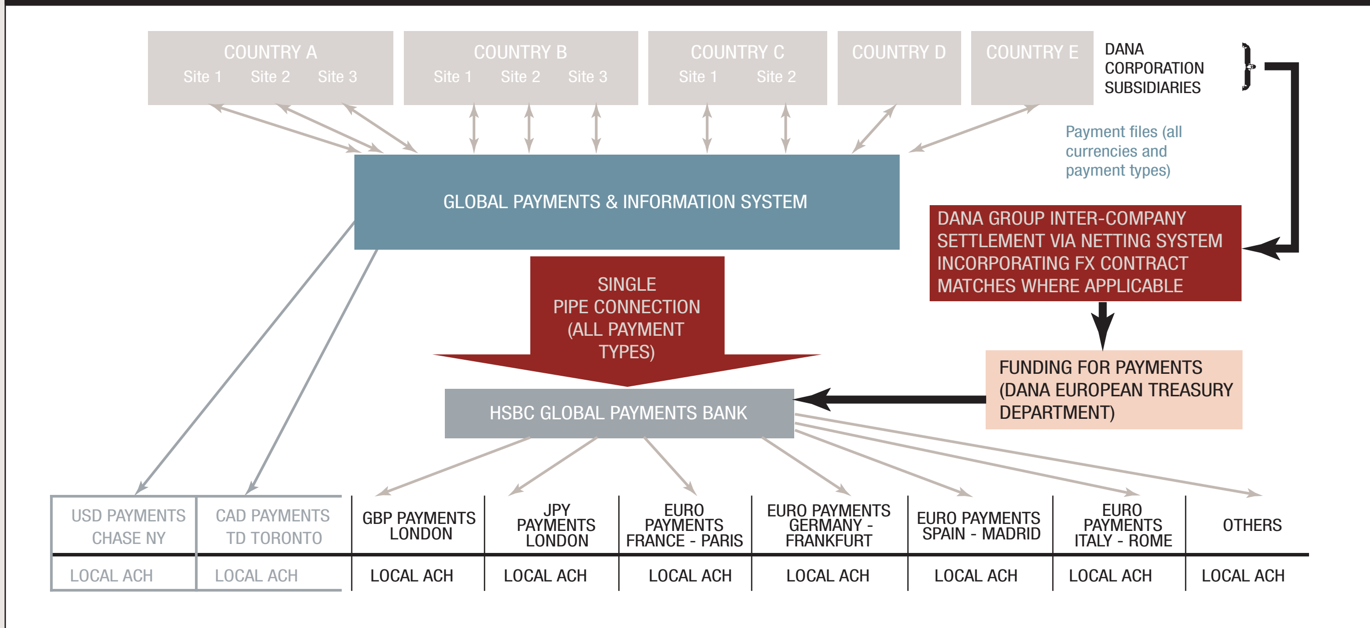
Dana Corporation designs and manufactures products for the world's major vehicle producers. A leading supplier of axle, driveshaft, engine, frame, chassis and transmission technologies, Dana employs 46,000 people in 28 countries. The company is based in Toledo, Ohio, and reported sales of $9.1bn in 2004. The company has a centralised payment function that has already evolved from the US to Europe; the next step in the process is to add on the group's payables for Asia.

Many companies within Europe have already dealt with the principal issue of liquidity management by establishing in-country cash pooling. With the advent of the euro, these companies have moved on to pan-European cash pooling. Once this key objective of efficient liquidity management has been tackled, other issues can be considered; one of these is centralised payments.

The manifold benefits of centralising payments for a multinational group include:

- Centralisation of payments provides better information about where payments are made and the purpose of these payments. It is

Figure 1. Dana Corporation European Payments and Information System



extremely valuable for the purchasing function to have global spend data by supplier.

- It gives improved control over cashflow with disciplined routine for payments.
- It leads to a reduction in the overall volume of payments by means of combining payments to suppliers that are common to various group companies.
- It significantly reduces bank charges by making payments whenever possible by utilising in-country low-cost clearing systems rather than making cross-border transfers.
- It allows lower-cost banking to be combined with electronic transfer of remittance details to suppliers.

In Dana's case the centralised payment system is used for third-party supplier payments. It has achieved a 30% reduction in bank charges from using in-country, low-cost clearing systems rather than making cross-border transfers, and has also produced a £45,000 reduction in communication costs by providing suppliers with remittance details via email.

Figure 1 illustrates the structure of Dana's centralised payment system. Files of suppliers and invoice data are transferred from each Dana location to the payment system daily and retained there until invoices are due for payment.

Standard weekly payment routines have been established that extract invoices due for payment, consolidate payments by supplier, and ultimately create a single payment file that is then transmitted to HSBC Bank in London.

HSBC then splits the file into payments to be made in each country and forwards these country files to the appropriate overseas HSBC branch so that payments can be made in-country through low-cost clearing systems.

Dana's system operates just as a payment system for its various subsidiaries and no liabilities are transferred from one company to another until the payment is made. Subsidiaries then settle their payment liability on a monthly basis via an inter-company netting system.

KEY FACTORS

The following items are of paramount importance in designing and implementing a centralised payment structure of the type described.

Lower bank charges The main savings come from lower bank charges, and it is important to identify and work with a bank with a truly global presence. Dana selected HSBC as it offered competitive pricing and a well-structured global solution. It is often better to work with the bank's product and technical staff to develop the design of the payment system. HSBC helped Dana's treasury and IT functions by establishing a multi-functional implementation team that dealt effectively with bank account documentation, technical questions on areas such as central bank reporting requirements and IT issues on payment file structures and communication.

Bank account structure The design of the bank account structure can be very important as certain countries have regulations that, for example, do not permit mixing resident with non-resident payments within the same account. In certain jurisdictions, in order to enter the low-cost clearing systems and obtain the most preferential fee structure, it was necessary to use a Dana resident company as a payment agent in-country.

Combined functions For a project of this type to be successful it is essential to bring together the legal, taxation and treasury functions to ensure that the global payment system solution does not create any tax or legal issues in any jurisdiction.

Legal deals Legal agreements with the bank and internally were established to ensure that costs and benefits were shared appropriately with a margin for the companies providing the services.

In addition, participating subsidiaries were charged an interest expense associated with the benefit they received in settling their payments later than they used to. Arms-length rates of interest are applied on this borrowing to ensure no conflict with tax authorities.

CASH POOLING

Dana had options in moving to a centralised payment factory. These options are relevant for any treasury wishing to move in the direction of cash management nirvana.

After a faltering start to the 21st century, due to trepidation about the euro and the much feared Millennium Bug, treasury projects have recovered. International cash pooling, which was previously often only considered by the larger multinational groups, has become widespread and the larger groups' activities have become even more sophisticated.

Although this development has not followed a uniform pattern it would be fair to say that the companies which have implemented treasury techniques have all benefited from the intangible benefit of having more readily available and more accurate information. This information has allowed these groups to control and maximise the return from their resources.

From a tax perspective, many of the potential issues connected with international cash pooling are also common to centralised payments. It should be borne in mind that although the minimisation of tax leakage is important, more often than not it will be commercial drivers which will determine the structuring of such a facility.

The major tax considerations to be thought through include:

- the location of the centralised payments hub;
- the creation of inter-company accounts;
- foreign exchange hedging;
- the allocation of centralised costs; and
- VAT.

The location of the hub Thinking purely in tax terms, the location of the hub in a low-tax jurisdiction or the use of a tax-efficient vehicle may at first sight appear attractive, especially if taxable profits could be shifted to the hub. Historically, for example, Belgium (through its Belgium Coordination Centres) and Ireland (through its International Financial Services Centres) have offered very beneficial tax regimes.

However, the ability of multinational groups to take advantage of these lower tax rates has become more difficult due to the introduction of legislation to prevent tax avoidance (for example, the Controlled Foreign Companies rules in the UK and Sub-Part F legislation in the US). Additionally, these lower tax jurisdictions or special tax vehicles frequently have restricted access to double tax agreements and there is therefore the potential for withholding tax costs to be incurred.

Experience to date suggests that the UK and the Netherlands, which have moderate rates of corporate income tax, remain favourite locations. This is often attributable to other treasury functions being located in these countries and their sophisticated banking systems.

Inter-company accounts The payment of invoices by a hub on behalf of other group companies will generally result in the creation of inter-company accounts between the two entities. As a result, consideration will need to be given to the terms of these inter-company accounts and whether interest should be charged on them.

The vast majority of tax jurisdictions have introduced transfer pricing legislation to prevent the artificial extraction of taxable profits. In very broad terms most transfer pricing rules allow taxable profits to be adjusted where excessive costs are charged to a company by a connected party or the company receives insufficient income from a connected party when compared to a hypothetical similar transaction with an independent third party.

The creation of inter-company accounts will therefore often require consideration to be given to repayment terms, the security to be offered, the rate of interest to be charged (if any), and the comparability of these terms with independent third-party terms. If the terms are not similar and a transfer pricing adjustment has to be made, there could be asymmetry in the taxation treatment between the parties, which could represent an economic cost.

The charging of interest on inter-company accounts could also have withholding tax implications. There are various ways in which withholding taxes can be mitigated – for example, double tax agreements, the EU Interest and Royalties Directive and local country planning – but as these techniques may not be automatically applied, the situation requires careful investigation.

One point to note is that if inter-company accounts run both to and from the hub, and interest is netted between accounts, withholding tax will generally be calculated on the gross amounts of interest rather than the netted amounts.

Foreign exchange matching The use of a centralised payment arrangement could provide for the centralisation of all foreign exchange exposure in the hub by allowing all participants, other than the hub, to use their local currency. This centralisation could give greater control over such exposure and allow for more efficient hedging, an area which has been significantly affected by International Accounting Standards, most notably IAS 39 *Financial Instruments: Recognition and Measurement*.

This centralisation could again have transfer pricing implications and groups would need to consider how any exposure/hedging costs should be recharged to participant entities.

Allocation of hub costs In addition to foreign exchange/hedging costs, the hub will often incur costs such as staff, premises and banking to name but a few. As with foreign exchange/hedging costs, transfer pricing legislation may require these costs to be recharged to the participants, the argument being that an independent third party would not provide such a service without the hope of making a profit.

There are various transfer pricing bases which could be applied, including cost plus comparable uncontrolled price, but whichever is selected it is generally recommended that the decision-making process and the policy itself should be thoroughly documented.

Value added tax The VAT treatment of a centralised payment arrangement will depend on the flow of any goods and services. There are various ways in which such arrangements can be established and therefore no one VAT model fits all. However, as with direct taxes, any avoidable VAT that is incurred will represent an economic cost of operating the arrangements. Therefore, time and money needs to be invested at the outset to ensure that there are no nasty surprises at a later stage

Although the best-laid plans should be the most tax-efficient, the tax environment is constantly changing and centralised payment arrangements need to be revisited on a regular basis to confirm their efficacy.

A full review of recent tax changes around the globe would fill many volumes and we have therefore selected just one for comment: the impact of the European Court of Justice (ECJ) decisions.

The European Union (EU) hopes that a common European system of taxation can be agreed. However, this could take many years to achieve, if indeed it is achievable at all. In the meantime, measures have been introduced to remove tax barriers across Europe. A good example of this is the EU Interest and Royalties Directive, which, subject to meeting certain conditions, removes the requirement to withhold tax on interest and royalty payments between companies in different EU states. However, of probably greater importance is the effect of the ECJ tax cases, which have concentrated on tax discrimination and the freedom of movement of capital. As a consequence of these cases, many countries are harmonising the tax treatment of transactions between nationals and the same transactions between a national and a non-national.

The recent Marks & Spencer case is an excellent example of such a case and is probably one of the hottest spots for UK tax. The case is concerned with whether losses incurred by EU member subsidiaries of a UK parent company can be offset against the UK parent's taxable profits, which would be possible if these subsidiaries were UK tax-resident. A decision is expected later in the year and, depending on the outcome, could result in an overhaul of not only the relevant UK tax legislation but could also have far-reaching effects on many European tax systems.

Although not directly relevant to centralised payments arrangements, the Marks & Spencer case is indicative of how domestic legislation could rapidly change due to European influences. Flexible arrangements may be capable of being quickly and efficiently adapted. However, the incidence of a constant tax-efficient treasury function may be a thing of the past.

REMOVING BARRIERS

So what barriers might restrict future developments in the cash management world? Treasurers have made it clear that the hardest internal barrier to move aside was the political 'in-country issues' across Europe. A close second was the question of adequate resources – who will actually do the extra work required and find the time to quantify the benefit by doing the real sums in respect of cost versus return on investment?

This article is based on a presentation at The Treasurers' Conference 2005.

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