Cash & taxes

IN THE FIRST OF A TWO-PART SERIES, SARAH BOYCE OUTLINES THE MAIN TAX REGULATIONS THAT MAY AFFECT CASH MANAGERS AND EMPHASISES THE IMPORTANCE OF WORKING CLOSELY WITH SPECIALISTS

In order to maximise shareholder wealth, firms seek to legitimately minimise their tax costs as returns to shareholders are paid out of taxed profits. This objective can only be achieved with full knowledge of the commercial transactions being entered into throughout the organisation and this includes treasury transactions, many of which fall under the remit of the cash manager. So it is extremely important that cash managers work closely with their tax colleagues or specialists brought in by senior management, particularly in the planning and implementation stages of any treasury project.

Tax treaties

Double taxation arises where two or more countries tax the same income or cash remittance. For instance, if a US-based company has a branch overseas, it is possible that the profits of the branch will be taxed both by the overseas authorities and (as part of the company's overall profit) by the US Inland Revenue Service. Tax treaties (also known as double taxation treaties) are agreements between two countries that set out the taxation rights of each country in respect of tax charged in the other. They are designed to facilitate international trade by avoiding double taxation.

When setting up new operations or planning the routing of income within an international group, it is important to consider which tax jurisdictions are involved. For example, if a cash manager was considering routing dividends from the US via a French holding company to a Swiss parent, then both the tax treaty between France and the US, and the treaty between France and Switzerland, would have to be taken into account.

In order to benefit from a treaty's rules, a company will usually have to seek prior approval from the tax authorities before making any remittances, so the cash manager must work closely with the tax team ahead of moving funds.

Permanent establishment

In most countries, income tax is only levied once a permanent establishment exists and, typically, tax treaties permit a certain level of activity in a foreign country before a permanent establishment is created. For example, a company may be running the sales operations from their home country, but warehousing goods and advertising in a foreign country. Normally, this would not create a permanent establishment.

But in some countries, merely holding a bank account can create a permanent establishment (for example, in Thailand) and the company can be taxed accordingly, so care must be taken whenever operating in a new country.

Controlled foreign companies (CFCs)

Usually, the profits of a subsidiary are only taxed at the parent level when they are distributed (for example, when dividends are paid) and so setting up a foreign company in a favourable tax location is a popular technique for avoiding domestic taxation.

But where a company has established an overseas subsidiary controlled by the parent purely in order to take advantage of favourable tax rates, most countries now have CFC rules that allow them to tax income immediately on recognition (ie tax is levied on the parent as soon as it is earned, before any distribution).

WITHHOLDING TAXES (WHT)

Where a company makes cross-border payments, typically of interest, dividends or royalties, it may have to withhold an amount from the payment and pay this to the domestic tax authority. WHTs are taxes on the recipient rather than the payer, and are levied as a means of collecting tax that would otherwise be payable on the income in the hands of the recipient. Each territory has its own rules on WHT; it is the rules that apply in the territory of the payer, not the recipient, that are relevant.

From the treasury perspective, the major areas where WHTs can be an issue are:

- **Dividends and royalty payments;**
- **Bank interest and gross-up clauses – financial markets work on the basis that interest is paid and received gross, ie without any tax deduction; all interest rates are quoted on this basis. If WHT is payable, most banks and other investors will require interest to be 'grossed up'. The lender receives the equivalent gross amount even after deduction of WHT. A gross-up clause preserves the investor's return, but places an additional potential cost on the borrower;**
- **Deemed bank interest applied by the corporate treasury as part of a cash pooling structure;**
- **Interest on intercompany loans including those created as a result of a cash pooling structure; and**
- **Payments considered 'in lieu of interest', such as arrangement fees.**

For example, a company that is resident outside the UK, but controlled from the UK, will be subject to UK CFC anti-avoidance tax rules.

Companies with genuine operations and substance in a foreign country should not be caught by such rules, but care should be taken when deciding the location and structure of special-purpose vehicles, including shared service centres or treasury companies, as they are frequently subject to close scrutiny by the tax authorities.

Interest income or income from intercompany lending activities may be subject to tax immediately on being earned if CFC rules are triggered. Even the location of the cash pool may invoke CFC rules.

Thin capitalisation (thin cap)

When a company sets up a subsidiary, there is a choice between debt and equity funding in varying proportions. Where a foreign subsidiary is tax paying, loading the subsidiary with interest-bearing debt can reduce the level of tax payable because interest on that debt is generally tax-deductible, even if the debt is intercompany.

In order to avoid this loss of tax income, tax authorities try to ensure that companies do not receive excessive levels of debt funding from other group companies through the introduction of thin cap rules (such as a minimum debt/equity ratio). Thin cap rules state that any debt above predetermined levels is treated as equity and the interest payment is treated as a dividend and taxed accordingly.

Care should be taken when implementing liquidity structures as these may trigger thin cap rules. For example, cash concentration structures where cash is physically pooled create intercompany loans that may be included as debt. In some jurisdictions, tax authorities may even regard a subsidiary with a debit balance in a notional cash pool as in effect 'borrowing' from the group for the purposes of calculating thin cap ratios.

Transfer pricing

Where two companies that are connected (for example, from the same group) trade with each other, the price at which goods or services are traded is referred to as the transfer price. By adjusting the transfer price, it is possible to make one company more profitable and the other less so. This has major implications for the amount of tax collected on the profits of each company, as transfer pricing can shift earnings from a high-tax jurisdiction to a low-tax one.

As a result, most countries have transfer pricing rules that require the connected companies to trade on the same terms as if with third parties (ie 'arm's length' or market price basis). In some jurisdictions, tax rules for transfer pricing now include domestic transactions as well as cross-border ones.

A central treasury operation or an in-house bank will attract particular attention from tax authorities in respect of transfer pricing.

Therefore, treasurers must ensure that:

- All intercompany loans carry a market rate of interest and are documented and signed;
- Commercial FX rates are used when transacting between group companies;
- Spreads are agreed for taking deposits or buying or selling currencies; and
- Fees for services such as netting, re-invoicing or providing a parental guarantee to secure lower funding costs must be fully documented and recharged among those members of the group that benefit from them (this also applies to other services provided to group companies and may be recharged under 'management service agreements').

Companies should always maintain documentation of trading relationships and provide evidence that the terms are at market rates. Sources of daily rates, such as Reuters, Bloomberg or *The Wall Street Journal*, are examples of independent sources that might be used to corroborate the rates applied.

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STAMP DUTIES

- **Stamp duty is a form of tax that is levied on documents (or transfers of some types of property). Traditionally, a physical stamp (a tax stamp) must be attached to, or impressed upon, the document to denote that stamp duty has been paid before the document becomes legally effective, hence its name.**
- **In certain countries, the execution of financial documents such as loan agreements (even for intercompany lending) may require stamp duties.**
- **Stamp duties can generally be avoided by not executing documents in those jurisdictions that levy them. But the tax can still become due if the document is 'repatriated' for legal or other reasons, so such documents may have to be stored as well as signed offshore.**

A second article, published later this year, will discuss the impact of taxes and local regulations on core cash management activities.

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