UK treasury operations stay at home

European group structures have treasury centres, yet UK multinationals ignore these tax-advantaged vehicles. Debbie Anthony of Arthur Andersen wonders why.

Establishing a dedicated treasury centre in a favoured tax regime to co-ordinate and manage the group's treasury function is a relatively common situation among European multinationals. In contrast, UK groups have traditionally preferred to retain their centre of treasury operations within the UK – limiting offshore treasury activities to the use of a finance vehicle acting as an intermediary between group borrowers and a group or third-party lender.

The current position

A poll of corporate treasurers in major UK plcs at a recent seminar revealed that 55% of the groups represented had no European finance vehicle or treasury centre. Among those that did, the Irish Financial Services Centre (IFSC) was the most popular location. This was followed by finance companies in the Netherlands and closely behind, Dutch and Luxembourg companies with Swiss finance branches. Belgian co-ordination centres (BCCs) were notably very low on the list.

These are among several well-established European tax regimes offering potentially significant tax and operational advantages for treasury and financing activities. So why are UK multinational groups so out of line with some of their continental European equals in continuing to run all, or substantially all, of their treasury operations from their domestic base?

There are undoubtedly important commercial reasons behind this decision, not least the UK's strong financial infrastructure and regulatory environment, as well as practical and logistical issues such as language, time differences and geographical location. In this article, however, we will focus on taxation – seeking to identify possible reasons for the current situation and speculating how some recent and proposed developments in tax, accounting and treasury may influence the pattern in future.

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Local tax benefits vs UK tax costs

Each of the favoured European treasury centre locations mentioned earlier and others besides, offer very significant tax advantages. Typical features are summarised in *Figure 1*. Taken together, these attributes can create an attractive tax regime with a very low effective local tax rate.

However, the UK is one of a number of countries that have enacted domestic anti-avoidance legislation to counteract the use of so-called controlled foreign companies (CFCs). Broadly, the CFC legislation requires profits of a non-UK resident company controlled by UK residents and subject to tax of less than three-quarters of the corresponding UK liability, to be attributed to the UK shareholders and subject to additional taxation. Many established treasury centre and finance company regimes are potentially within the scope of the legislation. Where it does apply, the additional UK liability on the attributed treasury centre profits may well outweigh any local tax saving.

Debbie Anthony

UK CFC legislation

UK CFC legislation is particularly sophisticated and goes some way to explaining the lack of popularity of treasury centres among UK multinational groups. However, the legislation is primarily intended as an anti-avoidance measure and does provide for a number of exceptions. Broadly, a CFC is exempt from an apportionment of its profits for accounting periods ending on or after 1 July 1999 if one of the tests summarised in *Figure 2* is satisfied. These have been abbreviated for the purposes of this article and reference should always be made to the detailed legislation.

The relevance of the exceptions to treasury centres and finance companies is limited. For example, domestic legislation in the finance company/treasury centre location will typically permit a wide range of treasury activities. These include:

- centralised cash, currency and risk management;
- intra-group financing;
- raising finance; and
- pooling and netting facilities.

For a UK group, such a broad range

of activities would probably be seen as investment business and the company would not be able to benefit from the exempt activities exception.

For many European groups, an attractive feature of some regimes is their ability to perform financial services for other than group companies. But from a UK perspective, lending to non-group companies may result in the requirement for a CFC to receive 90% of its income from group companies being breached and hence the CFC holding company exemption test failed. In short, it is difficult for a UK head-quartered group to undertake any treasury activities other than simple group funding in one of the favoured European treasury centre jurisdictions without falling within the ambit of the UK CFC legislation.

UK group treasury location

Leaving commercial factors aside, it is interesting to look at two established treasury centre regimes to assess whether their relative popularity with UK groups as suggested by the survey is supported by an analysis of the UK CFC provisions.

IFSC companies – Ireland has seen a substantial growth in popularity among UK groups as a favoured finance company location over the past three or four years. For example, Diageo has an IFSC company which provides a broad range of group treasury and business support services. Geographical proximity to the UK and the absence of linguistic barriers are two key practical reasons. These are reinforced from a tax perspective by a 10% corporate tax rate on trading income, the absence of withholding taxes on interest and a wide treaty network. However, the quota system for IFSC licences ended on 31 December 1999.

Irish domestic legislation also permits joint-venture type arrangements under which agency treasury companies or captive finance companies can operate with the assistance of a third party (eg, an existing IFSC bank or other service provider). Agency treasury companies (outside the formal quota system) can undertake a broad range of activities, whereas captive finance companies are restricted to providing intra-group financing primarily from internally generated funds. In either case, the service provider meets the substance requirements for the IFSC certificate. Captive finance companies are not intended to be used by financial services groups or major multinationals.

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From a UK perspective, the necessary substance requirements to help qualify for exception from the CFC legislation can therefore be more easily satisfied in Ireland, although very careful attention must still be paid to the CFC issue. Furthermore, where the IFSC company is both a finance and a holding company and its activities are principally financing in nature, there is a recognised dichotomy in seeking the 10% IFSC rate on trading income while arguing that the holding company exclusion applies in the UK.

Belgian co-ordination centres (BCCs) – in contrast, BCCs are not popular among UK groups, despite an attractive tax regime and a wide range of permitted activities. One factor is the significant substance requirements in Belgium. Another is that BCCs may not operate as holding companies and therefore cannot qualify for the potential CFC holding company exemptions.

Among European groups with BCCs, the centres perform a wide range of group services. This extends beyond financial services to advertising, scientific research and the centralisation of administrative functions. The few UK groups with BCCs are principally travel companies which use them as reservation centres, not finance vehicles.

FIGURE 1
Typical features of a European treasury centre regime

- no or minimal withholding taxes on interest;
- tax relief for interest payments;
- reduced rates of or exemption from tax on income from financing activities;
- a favourable basis of taxation;
- no or low capital taxes; and
- a formal ruling system to confirm the tax status of the company.

Recent developments

Current trends in tax, accounting and treasury can be predicted to have significant implications for the financing structure of groups and also to reinforce the existing pattern of UK multinationals retaining primarily UK-based treasury functions.

EU tax harmonisation

Moves towards removing harmful tax competition in the European Union (EU) and increased co-ordination of European tax regimes may result in some current tax benefits being progressively withdrawn. Many established financing centres are threatened by these measures. For example, the Irish government has been forced to replace the 10% rate on IFSC trading income with a general reduction in the Irish tax rate to 12.5% from 1 January 2003. The existing regime for IFSC companies licensed prior to 31 July 1998 continues until 31 December 2005.

There is also evidence that countries are tightening up their ruling procedures in response to pressure from the EU – for example in the Netherlands. The new Netherlands finance company regime effective from 1 January 1999 has succeeded in attracting a number of Dutch parent companies with treasury centres elsewhere back to the Netherlands, but has had little impact on investment from other multinational groups.

Accounting for derivatives

Last year saw the introduction of a new UK accounting standard FRS 13 (*Derivatives and other Financial Instruments: Disclosures*) and a new US standard FAS 133 (*Accounting for Derivative Instruments and Hedging Activities*). A detailed explanation of each is beyond the scope of this article but each has implications for group financing methods and structures.

The introduction of FRS 13 will result in disclosure of tax risks associated with structured transactions, the objectives and purpose of major transactions and

FIGURE 2

Summary of exceptions from UK CFC legislation

- **acceptable distribution policy** – broadly requiring 90% of the CFC's net chargeable profits for an accounting period to be paid out within 18 months of the end of that period;
- **exempt activities** – throughout the period the company must have 'substance' in the country of residence (eg, a physical presence and effective management) and undertake exempt activities. A CFC cannot normally be regarded as engaged in exempt activities if its main business consists of an investment business. There is an exception to this general rule for certain types of holding company, broadly those that are receiving at least 90% of their income from group companies;
- **publicly quoted** – specified criteria must be satisfied for the company to be regarded as publicly quoted;
- ***de minimis*** – chargeable profits must not exceed £50,000 for a 12-month period;
- **excluded countries list** – companies resident in one of a number of 'excluded countries' specified in the legislation are exempt, subject to certain requirements being met; and
- **motive** – any reduction in UK tax is minimal, or not the main purpose of the CFC and the main reason for the CFC's existence is not to divert profits from the UK.

will also highlight areas of discrepancy between tax and accounting treatment. This will encourage greater centralisation of finance and treasury functions and will in addition make it increasingly difficult to justify a *bona fide* treasury centre offshore.

The US is one step ahead and FAS 133 imposes a requirement for balance sheet recognition of all derivatives at fair value. Qualifying for hedge accounting will be a privilege, not a right, under the new regime. These new requirements are likely to result in increased concentration of treasury activities in special-purpose treasury centres by US groups. The need for a European treasury centre for such groups remains driven by accounting requirements but tax and regulatory considerations will determine the precise location.

Cash management and pooling

In the current marketplace, there is a drive for treasurers to better manage cash pooling – a trend given added impetus by the introduction of the euro. The need for cost savings and better control will in many cases simply strengthen the case for treasury functions to be brought back within head office. Our experience suggests that under cash pooling arrangements, the pool header account is typically located in the country of the head office unless there are significant tax or regulatory reasons to locate elsewhere. This provides further justification for UK groups to retain centralised activities in the UK.

Implications

This article has deliberately focused on potential tax issues influencing UK groups when deciding where to locate treasury centres or finance companies. The UK CFC legislation is just one factor – others such as thin capitalisation legislation imposing debt:equity or interest cover restrictions on intra-group funding cannot be overlooked. However, the implication that can be drawn from recent developments is that in the longer term, the emphasis in decision-making will be shifted from tax to commercial and operational advantages.

This raises some interesting possibilities. One is a reversal of the traditional pattern among European groups, who may increasingly find that the non-tax benefits of retaining central control of treasury activities in their home country location outweigh potential tax advantages of basing these elsewhere. This would bring continental European groups more in line with UK headquartered groups.

A second unintentional side-effect of these changes could be renewed interest in Switzerland as a treasury centre or finance company location. It offers an attractive tax and financing regime and a central European location without being in the EU, but careful exit strategy planning is required.

It is probably premature to predict the demise of European treasury centres. Accounting considerations suggest that they are likely to become more attractive to US groups. Recent developments both in the domestic tax legislation of European countries and towards co-ordination of regimes throughout the EU suggest however that factors other than tax will play an increasingly important role in determining the ultimate location of a multinational's treasury operations. ■

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