Why treasurers need to know about tax

Tax and treasury should be brought together as a single function at the lowest possible level, argues John Muirhead of Britax International.

Two hundred years ago the government's treasurers of the day brought income tax into being. I imagine that, if tabloid journalism had been around then, the headlines might have run along the lines of 'New tax to halt European expansionism'.

It is ironic that in the year in which our fellow tax professionals are celebrating the bicentenary of the creation of income tax, we treasurers are witnessing the introduction of the single European currency which appears to be one of the first stages towards a United States of Europe.

The next stage in the progression to a United States of Europe, which has come more into public consciousness of late, is tax harmonisation among the EU member states. While it is inconceivable that a new tax could halt European expansionism in the way Napoleon was halted nearly 200 years ago, it is equally incongruous that member states could (or even would want to) harmonise quite so easily the conceptual bases and practical interpretations which differentiate their tax systems – even if the rates of business tax were harmonised!

In short, it will be a long time before harmonisation will do for European tax systems what the euro is going to do for foreign exchange.

Substantial employment

By contrast with the likely effect of the euro, the birth of income tax generally made commercial life much more complex than before; it also created, over the past two centuries, substantial employment as well as an entirely new branch of the accountancy profession. Some may well say an entirely separate profession!

Throughout modern economic history, treasury and tax have, by the very nature of their knowledge base, been separate specialisms but, as the above historical analogy demonstrates, they have shared such similar ground, and at times have been so interwoven, as to be virtually inseparable.

> The two specialisms of tax and treasury will seriously underperform their combined potential unless they are merged together at the lowest possible level within the organisation

At Britax, as the group treasurer responsible for a very lean treasury department at a time of significant change and re-focusing of the group, I am acutely aware of the necessity to get the right balance between tax and treasury.

Previously, we managed to get by without our own internal dedicated tax capability. But as the group's focus became more defined and its reach more global, and the number and complexity of acquisitions and disposals increased, it became imperative that we engage a full time tax specialist.


John Muirhead

Whilst it might be a slight exaggeration to say that I do not know how we managed before, there is absolutely no doubt at all that your tax department, and, when the need arises, outside tax advisers, perform a crucial role in supporting your activities as a treasurer. You, as treasurer, should understand the major tax issues and hence the advice given by your tax department and advisers. But, it is absolutely essential that they understand what you do and that they take this into account!

Commercial considerations

If communication breaks down, then the probability of missed opportunities and expensive mistakes will increase significantly. Some of these mistakes and missed opportunities will rarely get spotted – even in the tightest of ships. Sometimes it will not matter – perhaps because commercial considerations override any tax consequences and the transaction would have gone ahead regardless – nevertheless this cannot be regarded as an acceptable situation.

Nor should getting the right balance be simply passed off as a question of good or bad communications. Perhaps a more important determinant of effectiveness is the way in which these two specialisms are being organised, controlled and managed. While tax and treasury are separate specialisms they should not, as increasingly seems to be the case, be treated as separate operating functions.

The purpose of this article, therefore, is to persuade finance directors, those engaged in organisational structure and treasury and tax professionals alike, that in a corporate environment the two specialisms of tax and treasury would seriously underperform their combined potential unless they were merged together at the lowest possible level within the organisation.

Interconnectivity

The interplay of treasury and tax in modern commercial life is so subtle that there is a distinct danger of them being regarded as two entirely separate functions. In fact some organisations – mistakenly, I believe – even have two specialist individuals reporting at board level.

Whilst it is true that most treasurers are non-tax specialists, many of them know instinctively that they need to be, at a minimum, 'tax-literate'.

Of course tax cannot be ignored in even the simplest of transactions, and the analysis of tax is becoming more and more complicated. Taxation has, without doubt, a substantial impact upon the bottom line and for multinationals operating in various tax jurisdictions there is a plethora of opportunities for minimising the overall tax burden and maximising shareholder value.

Many of these opportunities often require the treasurer to not only operate, but at times even think, in a different way than would otherwise be the case. Unless the treasurer is at least 'tax literate' and has a good knowledge of the overall tax position he or she cannot contribute to the process or make the necessary adjustments in thinking.

Organisational structure and reporting lines

Value-added processes of treasury and tax differ quite markedly from each other. The former, being predominantly transaction-driven, can be likened to water being continually dripped onto a stone whereas the latter, being mostly project-driven, can be characterised as the occasional flash-flood.

As everyone knows, taxation, apart from being a very large number, hits the bottom line in a very high-profile, tangible and easily-identified way. Shareholder value can be significantly enhanced by judicious management of the effective tax rate. Consequently, the tax function – in particular, tax planning – becomes a highly-focused activity which lends itself to being organised and motivated along profit-centre lines. Investment project methodology has a role to play which is well suited to the clearly defined and accurately measured benefits that can accrue from specific tax strategies.

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Most treasury processes, by contrast, are transaction-based and treasurers achieve their added value objectives not so much by one-off projects but more by continuous churning of liquid resources. Also, most treasury functions are organised on cost centre lines, particularly in non-financial services organisations, and even though performance measurement is essential, there is inherent in most treasury transactions a much greater degree of uncertainty of outcome than most tax projects. The outcome of the former is subject to the vagaries of the capital, foreign exchange and commodities markets whereas the latter deals mostly with legal liability.

The usual division of responsibilities between tax and treasury is that tax directors or managers, sometimes with little involvement from the treasurer, are instrumental in driving the creation of a new tax structure.

Those who would favour greater separation of tax and treasury would argue that the overall tax rate is the responsibility of the tax director or manager and combining tax and treasury at a lower level in the organisation would dissipate focus.

Equally, the separatists would argue, interest (paid and received), currency gains and losses and balance-sheet hedging would be regarded as the preserve of the treasurer, and the

Interconnectivity of tax and treasury

The following examples illustrate the interconnectivity of tax and treasury:

- the decision as to whether a company funds its aggregate requirements by debt or equity, or if both in what proportions, is influenced by the tax treatment of dividends and interest payments in the relevant jurisdictions;
- the relative liquidity or illiquidity of the equity, bond or debt markets, and accordingly the cost of these different forms of capital, will be substantially influenced by the tax rules applicable to these different types of investment;
- for multinationals the decision as to whether subsidiaries are funded by equity from the parent, intra-group debt or local bank debt depends very much on the after tax impact;
- how much intra-group debt can be supplied will depend upon 'thin capitalisation' rules in the borrower's country and, as importantly, on the profits, and therefore the interest cost that may be relieved, of the subsidiary concerned;
- the decision as to the choice of currency in which intra-group cross-border debt is denominated will be heavily influenced by tax treatment of foreign currency gains and losses in the respective jurisdictions;
- the decision as to what should be the routing for cross-border intra-group debt will depend upon the treatment of withholding taxes and the local tax interpretation of 'distributions';
- transfer pricing rules influence the interest rate and profit margin that a lender can charge on cross-border debt;
- whether intra-group debt is fluctuating or permanent may affect the taxation of currency gains or losses arising on intra-group debt;
- access to surplus funds, whether as part of a cash pooling or cash concentration structure or not, and the routing for the repatriation of these surpluses will also be heavily influenced by tax regulations in the respective jurisdictions; and
- the treasurer's ability to control liquid resources in a multinational setting will be limited by central management and control issues associated with tax residency and CFC regulations.

management of risk should be guided by underlying economic reality.

But those who favour separation do not fully appreciate the interaction of tax and treasury across a wide range of activities. Furthermore, separation places enormously heavy burdens on effective communication. A tax director or manager pursuing a single objective of lowering the effective tax rate can significantly inhibit the treasurer's ability to reduce debt levels and borrow in the lowest cost manner.

Moreover, treasurers at times have to move rapidly in response to changing market conditions and must therefore be able to make quick judgements as to what pre- and post-tax effect his or her decisions will have on both the reported bottom line and cash flow. When the market is moving rapidly against you, it is usually not the best time to be engaging in cross-departmental communications especially if the tax department are working to achieve deadlines on their own high priority projects.

Furthermore the separation of tax and treasury at higher levels within organisations would run a greater risk of being caught by anti-avoidance clauses in tax statutes. Tax should rarely be, or moreover be seen to be, the primary purpose for undertaking any transaction (ie the tax tail should not wag the economic dog).

Conclusions

Surely then, optimal tax solutions can only be possible when tax and treasury specialisms are either merged, or when the tax director or manager and treasurer together are given joint responsibility for the successful outcome of particular tax strategies. (Such solutions are not only those that analyse the tax consequences of a particular transaction or structure but also those that answer questions such as what structure or transactions should there have been in order to give the best pre-tax and post-tax results).

Rewarding one at the expense of the other would undoubtedly create organisational tensions that would be to the detriment of the organisation as a whole. To achieve the best from tax and treasury, these two specialisms should be brought together as a single function at the lowest possible level within the organisation.

Corporates should resist the temptation to view the tax department as a 'profit centre' while viewing treasury as a 'cost centre'. Treasurers cannot operate effectively if communication structures between them and tax specialists are poor or non-existent, overly cumbersome or, worse still, scrambled because of competing or conflicting priorities.

Treasurers should know and understand the tax position of their organisation and the tax environment in which it operates.

After all, if history is to teach us anything, it is that when tax and treasury resources are combined in pursuit of a single objective they are a formidable force – as Napoleon learned to his cost! ■

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