How Taxation Impacts on Liquidity Management

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Executive Summary

- Efficient cash and liquidity management will involve centralizing cash within a single entity, on a country, regional, or even global basis.
- The movement of cash between entities and between countries will create complex tax considerations, so that all loans and rates of interest applied must be at arm's-length pricing.
- The cash centralization is normally arranged with the group's bankers who can offer a notional pooling or a physical movement of cash.
- Interest payable on the balances arising from the cash centralization or from the overall funding structure of the group can be subject to withholding tax (WHT), which may be reduced to zero by tax treaties or may be reclaimable through a variety of mechanisms.

The Basis for Taxation

Taxation is highly dependent on the specifics of the companies concerned and the tax jurisdictions to which they are subject. Nonetheless, there are sufficient structural similarities between countries so that background generalizations can be made, although the specific rules and tax rates vary over time and will need to be verified with local tax experts.

Tax is initially assessed on the basis of each legal entity in isolation, but various allowances exist that enable operations to be examined from a group or subgroup perspective.

The legal grouping of companies, the managerial grouping, the accounting grouping and taxation group may each be on a different basis.

Taxable profit is not calculated in the same way as accounting profit. The latter may be generated using IFRS (International Financial Reporting Standards) or local GAAP (Generally Accepted Accounting Principles) using cash accounting or some taxation specific rules.

Efficient liquidity management for an international group involves making best use of the cash resources existing or being required or generated across the group.

In order to manage the daily flows of cash across the group there are normally efficiencies to be gained by centralizing cash flows within a central entity for each country or region, or, if practical, globally. The consequent movement of cash around the group, whether buying and selling goods between companies, or lending cash backward and forward, have significant tax consequences, made complicated by the interaction of different national and international rules.

Tax is therefore a major issue in the selection of a treasury center location. Areas set up specifically to attract treasury may be located in tax environments where local taxes are low and where there is special treatment of foreign earnings. They will be located in countries with extensive tax treaties, and there will be no WHT on interest earned or paid, or on income from dividends. These locations should also enable the repatriation of profits without tax deductions. Note, however, that in common with many business decisions, tax is not the only factor. Issues over staff availability and retention, proximity to management and major investors (for example, in London) are equally important factors.

Transacting with Connected Parties

Transfer Pricing

Most developed tax systems contain provisions that allow the tax authorities to increase the taxable profit, or reduce the allowable loss, of an entity which has entered into transactions with affiliates on non-arm's-length terms. In some jurisdictions, including the United Kingdom, this now includes domestic transactions as well as cross-border items. The concern for tax authorities is that profits are artificially moved between countries and, in particular, from a high tax area to a lower tax area.

Transfer pricing rules concern the provision of services as well as goods, and so they affect not only intragroup funding and hedging arrangements but also the provision of centralized treasury services. From a practical perspective, this means that apart from keeping contemporaneous documentary evidence of group transactions:

- all intercompany loans should carry a market rate of interest or other finance charge;
- commercial foreign exchange rates should be used when transacting between group companies;
- central treasury services should be recharged among those group members that benefit from them.

In-house re-invoicing and factoring centers usually receive particular scrutiny from the tax authorities of all the countries where participating group members are based.

Thin Capitalization

A company is said to be "thinly capitalized" where it is particularly highly geared. The tax authorities are concerned to ensure that companies do not receive debt funding from affiliates at levels that mean their profits are largely sheltered by interest expense. Many jurisdictions have now passed rules that set out what they consider to be an acceptable level of gearing for tax purposes. In some cases, for example in the United States, Germany, or Australia, the rules prescribe a maximum debt/equity ratio or required interest cover, and in others, such as the United Kingdom, the rules restrict finance charges by reference to the company's capacity to borrow from a third party on a stand-alone basis. Where the acceptable level of debt is based on subjective tests, it is frequently possible to secure advance clearance from the fiscal authorities on the proposed level of gearing.

In the UK a new debt cap takes effect for accounting periods beginning on or after 1 January 2010, running in parallel with the arm's length principle. The debt cap applies to limit the tax deduction for finance expense payable by UK group companies by reference to the consolidated worldwide gross finance expense of that group. This is intended to counter the risk that groups with little or no external debt may nevertheless leverage their UK operations to reduce UK corporate taxes. There is a risk that interest deductions on intragroup loans could be denied in the UK, while the corresponding receipt remains taxable in a foreign country.

For companies, the downside is that if transfer pricing or thin cap rules are breached a tax deduction for interest expense may be denied, while at the other end of the transaction the lending company is still taxed on the interest income.

Withholding Taxes

WHT is a tax that is deducted at source on earnings, which include employment income, dividends, and interest payments, and can also include intangible services. It is a charge on the recipient. It is not tax that is charged on the remitter and has no effect on tax payable by the latter. This tax is withheld by the remitter and is paid over to the domestic tax authority in which the income arose. A tax treaty may lower the withholding rate between certain countries—sometimes to zero. Double tax relief may also be available to offset WHT against a domestic tax liability. It may be necessary to apply in advance in order to obtain the reduced rate. As there are considerable differences in WHT rules between countries, companies need to carry out due diligence at the country level first and then look at the tax treaties that are available in order to obtain a full appreciation of the impact of WHT on their activities.

From a liquidity perspective, the major areas where withholding taxes can be an issue are:

- Dividends and royalties.
- Bank interest applied at source: The company may, or may not, be able to reclaim or deduct the WHT from income when the corporate tax return is filed, but there is inevitably a cash flow delay.
- Deemed bank interest applied by the corporate treasury, for example when reallocating interest on deemed bank interest arising from a notional pool. In some countries, such as the United Kingdom and the Netherlands, banks pay corporate interest gross, i.e. without deduction of WHT. This is one of the reasons why these countries are popular as cash pool centers.

- Interest on intercompany loans applied by the corporate treasury or created by cash concentration sweeping.
- Payments considered “in lieu of interest,” such as guarantee and arrangement fees. The tax is due irrespective of whether or not an actual payment was received or a charge made for the service.

The WHT tax paid may become a final tax burden for the lender if it cannot be refunded or claimed as a tax credit or deduction. In some countries the WHT can be offset against corporate taxes due.

Tax Treaties/Double Tax Relief

Tax treaties (also known as double taxation treaties) are a set of bilateral agreements between two countries that set out the taxation rights of each country in respect of tax charged in the other.

When a company receives income from overseas that has been taxed at the local level there are three options in dealing with the potential for double taxation. In order of most advantageous to the company:

- If the tax treaty calls for participation exemption (which prevents the same income from being taxed twice), the income may not be taxed again at the shareholder level.
- The overseas tax is used to offset and reduce any domestic tax liability, i.e. the amount of the tax already paid reduces the amount of the tax due at home by an equal amount.
- The overseas tax may simply be allowed as a tax deduction against domestic tax liability, i.e. the tax paid overseas is used as a deduction against income, thereby reducing taxable income.

Tax Implications of Notional Pooling

Notional pooling means that credit and debit balances of various companies are notionally aggregated and netted by the group’s bank, without actual transfer of ownership of the funds taking place. The following issues are associated with notional pooling:

- Notional pooling is usually considered to be a form of bank lending and treated as if interest is paid to the bank, although in fact the interest may actually be paid through intercompany transactions.
- Transfer pricing regulations require that any interest paid as an intercompany transaction is reallocated to the subsidiaries on an arm’s-length basis.
- Transfer pricing will also look into the issues of pricing for the value of cross-guarantees that would normally be paid to a third party.
- There may be withholding tax (WHT) on the interest paid through intercompany transactions.
- A debit balance in a notional pool may also be used to calculate thin capitalization ratios.
- Notional pooling requires cross-guarantees and a legal right of offset to secure the position of creditors. Strictly, both these should be charged for.
- Legal constraints, such as not allowing cross-border legal right of offset, prohibiting the co-mingling of resident and nonresident accounts or requiring central bank reporting and reserves to be maintained on a gross basis, render pooling unviable or difficult in some countries.

Tax Implications of Cash Concentration

With cash concentration, the funds move physically into the concentration account, with a resulting change of ownership. These are the major issues that arise from cash concentration:

- It creates intercompany loans and is taxed accordingly.
- No cross-guarantees or legal right of offset are required.
- Transfer pricing regulations require that any interest paid as an intercompany transaction is reallocated to the subsidiaries on an arm’s-length basis.
- There may be WHT on the interest paid through intercompany transactions.
- Thin capitalization is likely to be an issue.
- It may attract deemed dividends.
- In some countries there may be additional stamp duties on cross-border intercompany loans (for example Austria, Italy, Portugal).

- Regulations prohibiting cross-border transfers will restrict participation in an overseas concentration scheme.
- Reference accounts are a way to pool cash without transfer of ownership.

Making It Happen

- Taxation considerations should be built in at an early stage in the planning of liquidity management structures and processes.
- The best location for a cash management center will often be within a country with an extensive network of tax treaties and with no WHT on interest or dividends.
- Intra-group financial transactions should be priced at market prices (including margin where appropriate), and there should be contemporaneous independent documentation in place to support the prices used (for example, Reuters, Bloomberg, or the *Wall Street Journal*). Justification of margin can be more subjective. Possible comparators might be alternative facilities offered by banks locally or perhaps bond spreads, or credit default spreads (from Markit for instance).
- Where there is a central treasury operation or an in-house bank, borrowing rates and other terms and conditions should be formalized in the same manner as they would be with an external commercial bank.
- The same applies where a parent company is obliged to guarantee a subsidiary as a means of securing the subsidiary a lower borrowing rate. The parent should charge a guarantee fee.
- Structures such as “shared service centers,” where a centralized group resource provides services to affiliates, also attract particular attention from tax authorities. Pricing and service levels should be similar to those that might be offered by a third-party provider.

More Info

Websites:

- Deloitte International Tax and Business Guides: www.deloitte.com
- “How to Manage Your Global Liquidity—A six part guide”: www.gtnews.com/feature/85.cfm

See Also

Best Practice

- Managing Liquidity Risk in a Financial Institution: The Dangers of Short-Term Liabilities
- Understanding the Requirements for Preparing IFRS Financial Statements

Checklists

- Comparative and International Financial Regulation
- International Financial Reporting Standards (IFRS): The Basics
- Overview of Tax Deeds
- Understanding and Using Interest Coverage Ratios
- Understanding the Key Components of GAAP: The Continuing Concern Concept

Finance Library

- Taxes and Business Strategy: A Planning Approach

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