6.1.2 Forms of Ownership and the Financing of Operations Self-Test Questions

Unit: Unit 2 – Treasury Applications

Module: Module 6 – Managing corporate structure

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Summary: Self-test questions in ownership and financing of operations

Keywords: taxable profits, debt, equity, capital structure, non-recourse, comfort letter, minority

Question 1
What is the fundamental principle as to where, ideally, group borrowings should be located?

Question 2
Other than company policy and characteristics such as lack of taxable profits or volatility of cash flows, what is the main external constraint on maximising leverage in high tax regimes?

Question 3
Explain how financial market imperfections can be exploited by the global firm.

Question 4
Why is the tax differential between the costs of debt and equity often increased when financing internationally?

Question 5
What is meant by the statement that the subsidiary has no independent capital structure?

Question 6
How can comfort letters, which are not legal guarantees, reduce the cost of group funding?

Question 7
What influences can minority shareholders bring to bear and why can they sometimes not be avoided by the multinational?

Question 8
What are the aspects to consider in decisions around ownership and financing of operations?

Question 9
Apart from trade items, how can money flow up and down a group of companies?

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Question 10
What might be included in a shareholder agreement?

Question 11
What are the implications for treasury of financing a subsidiary on a non-recourse debt basis?

Question 12
If a subsidiary has a minority, what problems might this give in loan agreements?

Answers

Answer 1
What is the fundamental principle as to where, ideally, group borrowings should be located?

Borrow as far as possible through entities in high-tax regimes, provided they have sufficient tax capacity. Of course, if there is a minority this may change the outlook and if a really high risk / high reward approach is taken, then this may also trump the tax reasons. This answer is on the basis of deductibility for tax of interest expense, which is broadly under threat in the late 2010s.

Answer 2
Other than company policy and characteristics such as lack of taxable profits or volatility of cash flows, what is the main external constraint on maximising leverage in high tax regimes?

Local thin capitalisation rules which set an upper limit on tax-allowable gearing. Interest paid on amounts of debt above this level will usually be taxed as dividends ("deemed dividends").

Answer 3
Explain how financial market imperfections can be exploited by the global firm.

Financial market imperfections are things such as lower real interest rates, local subsidies on interest rates, "soft" loan terms, special tax concessions relating to borrowing costs and grants. This allows the global firm the opportunity to reduce its average cost of debt funding.

Answer 4
Why is the tax differential between the costs of debt and equity often increased when financing internationally?

Withholding tax on interest is usually higher on remittance of dividends than on interest payments. This is in addition to the normal corporation tax deductibility of interest while dividends are not tax deductible.

Answer 5
What is meant by the statement that the subsidiary has no independent capital structure?

Subsidiary funding / capital structure is usually not decided simply on a stand-alone basis but reflects both local and group considerations relating to availability of equity and debt, relative costs of borrowing, tax-security opportunities, restrictions and taxes on dividends, thin capitalisation rules etc. Even without parent company guarantees the debt of all subsidiaries ("controlled" by definition) is on the group balance sheet. Therefore, in a sense, the capital structure of the subsidiary is that of the group. In addition, intercompany financing may be considered to be de facto equity, as it is at risk in the same way.

Answer 6
How can comfort letters, which are not legal guarantees, reduce the cost of group funding?

A comfort letter should enhance the credit status of a borrower and allow cheaper loan finance. So they may well reduce the cost of borrowing by the subsidiary but without the negative effect on the parent company's credit rating that a guarantee would have, which (in theory) would increase the parent's borrowing costs. In short – getting the benefits of an "implied guarantee" without giving an actual guarantee. However, they may be considered a de facto guarantee as there might be a very high cost to reputation for a parent to renege on a comfort letter or indeed to allow a subsidiary to default.

Answer 7

What influences can minority shareholders bring to bear and why can they sometimes not be avoided by the multinational?

The minority shareholding might press the majority shareholder to provide additional finance, guarantees, undertakings or support services which are either not expected of the minority shareholding or cannot be provided by them. Although the majority shareholder usually has "control", maybe this is the price of control.

Answer 8

What are the aspects to consider in decisions around ownership and financing of operations?

Aspects centre on:

Risk, reward, ownership and financing. Accounting effect might be considered an additional consideration.

Answer 9

Apart from trade items, how can money flow up and down a group of companies?

- Equity injection or in some cases reduction of capital
- Dividends
- Loans
- Royalties
- Fees and charges

Answer 10

What might be included in a shareholder agreement?

- Financing
- Further investment
- Dividends
- Fees and charges
- Royalties
- Board membership
- Exercise of voting rights

Answer 11

What are the implications for treasury of financing a subsidiary on a non-recourse debt basis?

The entity is most likely to ring fenced from the parent, with no dividends, loans up, reduction in capital etc, allowed, except in cases of very low gearing. So it cannot be in cash management arrangements such as pooling, but it might be able to participate in multilateral netting and might be able to do FX deals and other arm's length transactions.

Answer 12

If a subsidiary has a minority, what problems might this give in loan agreements?

These subsidiaries are (subject always to definition) subsidiaries for the purpose of loan agreements and might therefore:

- Have to comply with the covenants contained in them, unless specifically carved out.
- Be required to give security, although this would disadvantage the minority.
- Be required to give guarantees in support of the group debt.
- Cause a cross default if local non-recourse debt goes into default.

Depending on circumstances, it is possible to 'carve out' a subsidiary to avoid these issues.