6.2.1 Tax and Treasury

Unit: Unit 2 – Treasury Applications

Module: Module 6 – Managing corporate structure

Date: 1 September 2016

Summary: Highlights of the common tax issues for treasury. Provides an understanding of typical tax strategies and their related financial risks set in the context of a global group, including transfer pricing, withholding tax, anti-avoidance measures such as controlled foreign companies, and implications for hedging. A brief look at the future of tax.

Keywords: treasury management, taxation, pooling, cash concentration, BEPS, BAT/DBCFT, withholding

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Learning outcomes:

1. Close relationships between tax and treasury is important.
2. While different perspectives are found, Effective Tax Rate and cash tax paid are important measures.
3. Tax compliance, in corporation tax and other taxes, such as sales taxes, is important.
4. There is risk in tax, planned risks and unplanned risks.
5. There has been debate about responsibility to pay tax against maximising shareholder wealth. Tax evasion is unlawful while tax avoidance is quite usual.
6. Strategic tax includes: ensuring full compliance with all tax laws globally; optimisation of a set of key tax performance metrics; driving a competitive advantage through post-tax enhancement; resolving all tax disputes and uncertainties in a timely manner; reducing tax risks.
7. Tax risk includes political risks.
8. They materialise as: financial cost (including interest and penalties); reputational damage (where public visibility); operational disruption and cost (if assets are sequestered); drain on resources (in defending enquiry).
9. Tax risks can last for many years and survive several changes in staff.
10. Deferred tax allows a sensible approach to ETR.
11. Tax systems (apart from the US) are moving closer to accounting profit.
12. Group structure can vary and typically each country has a trading company or a holding company if there is more than one company in a country holding companies allow profits and losses to be grouped, where allowed in the country.
13. Internal capital structure can be manipulated to alter the tax base although arms length principles must be adopted on intercompany charging and there are often limits on debt in subsidiaries, for example.
14. The location of holding companies and treasury vehicles is often driven by tax considerations.
15. Capital taxes are also important to corporations.
16. Transfer pricing legislation requires trading to be on an arm’s length basis and is hugely important to treasury because of the large number of intercompany transactions.
17. Base Erosion and Profit Shifting (BEPS) relates to an initiative to restrict the ability of mainly multinationals to reduce taxes paid.
18. Controlled Foreign Company (CFC) legislation attacks the ability of corporations to set up companies in jurisdictions to avoid taxes.
19. Cash pooling has tax consequences which must be fully understood.
20. Withholding taxes can create complexity and cost cash.
21. Tax treaties and double tax relief go some way to avoiding withholding tax and being taxed twice on the same income.
22. Derivatives should sit in the same taxable entity which is exposed to the risk that the derivative has been executed to manage.
23. The future of tax is more uncertain that in recent years. The UK will limit interest deductions and there is talk in the US of no deduction for interest.

1 Introduction

The aim of this reading is to take some of the most common issues that arise with regard to tax and raise “tax awareness” around them. Treasurers face tax issues in many areas and their relationship with the Tax Director will be very close and drive considerable value.

Firstly, though, it is important to understand the strategic viewpoint of Tax within the organisation. Groups will have very different perspectives depending on their geographical spread, risk appetite, corporate governance obligations, tax attributes, etc. Typically, most groups will tend to focus on their Effective Tax Rate (ETR), however, actual cash tax payments are increasingly receiving more attention, together with information on the total tax burden on the organisation.

This total tax burden concept recognises that companies both pay many different taxes to, and collect many taxes from others on behalf of, Governments, thus playing a fundamental role in the public funding. It is beyond the scope of this discussion to analyse non-corporate income taxes but suffice it to mention that there are many more taxes that a company manages than just Corporate Income Taxes. The distinguishing criteria for these other taxes is that they are either borne before the Taxation charge in the Profit & Loss account (i.e. within Profit Before Taxes, such as environmental and property taxes)) or are taxes that companies collect and pay over to the fiscal authorities (i.e. sales-type taxes, payroll, withholdings, etc). The organisation is exposed to significant penalties if it gets these taxes wrong, they burden the supply chain, and are typically significantly larger in amount than Corporate Income Taxes. Therefore, the Tax Director, nowadays, will be concerned with systems and compliance over the Total Tax burden. However, this analysis will focus on the direct corporate income tax management only, as this most closely links with areas that involve Treasury, but the wider base should not be forgotten.

Like the Treasurer, the Tax Director must carefully manage risk. However, due to lack of certainty in many tax areas, each organisation must assess its risk appetite in tax management, and more particularly tax planning. Typically, risk can be divided into “Unplanned Risks” and “Planned Risks”. For example, an engineering project that recognises inherent difficulties and proceeds, does so in the knowledge of the challenges and positively embraces the planned risks, for hopefully the planned rewards. Disruption in the project caused by unknown events, which perhaps could have been predicted and avoided, is a less palatable circumstance and represents “Unplanned Risk”.

The above is also true in taxation where organisations may undertake strategies to mitigate the burden of taxation in full knowledge of the related (planned) risks. In this sense, the organisation has positively taken on additional tax risk for an anticipated improvement in its post-tax results. However, common between Treasury & Taxation, is the goal to identify and minimise all unplanned risks. The Tax Director will establish a system of internal financial control to seek to address these risks and reduce them as far as possible.

Therefore, the key planned tax risks for an organisation surround its appetite for tax planning. There have been considerable debates and developments in this area over recent years, from professional tax advisers to fiscal authorities to academics, from the boardroom

to government. There can be no question that the organisation has a duty to maximise shareholder wealth and that, in part, will be seen as maximising post-tax profits or free cash flow. However, there is also a good corporate social responsibility (CSR) on organisations to pay their fair share of taxes for the public purse, and CSR is an increasingly important aspect of a company's brand. The divergence of these two themes potentially leads to conflict between organisation and government, which may be a risk that financially translates into a less than optimum shareholder position. Indeed, arguably a strong business tax responsibility drives a sustainable financial model which many believe naturally leads through to long-term shareholder wealth.

Having covered the strategic importance of tax in the organisation, and the related risks, we will look at the group structure, including internal funding optimisation. We then consider more tactical issues such as the importance of arm's length principles in the set up and day to day operations of treasury and how liquidity management is affected by taxation issues.

Tax and treasury are often combined in many firms and the two issues are very closely connected. No decision, from how to structure an acquisition or disposal to how to set up a business in a new country to cross border intercompany funding is taken without consideration of the tax consequences. Many treasurers thus become well acquainted with tax issues during their careers.

Tax and treasury also share the burdens and opportunities of very rapid and enormous change, from technology, regulation or markets and, in the case, of tax, legislation. Because of this, tax is an area where specialist advice is taken almost on a continuous basis, country by country. The treasurer needs to know the issues that will arise.

Taxation of multinationals is a very hot political topic. For example, in the UK, it has been highlighted how little tax some companies (e.g. Starbucks and Amazon) pay, despite having a substantial presence and turnover in the country. While the UK government has proposed a 'diverted profits tax' there is a worldwide initiative by the OECD/G20, called Base Erosion and Profit Shifting (BEPS). Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies that exploit these gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises (MNEs). For more information, see:

http://www.oecd.org/ctp/beps-about.htm

As if BEPS wasn't enough to worry about, the election of Donald Trump has (under advice) brought new ideas on taxation to the fore, to replace what is often seen as a broken system. Step forward 'destination based cash flow tax' (DBCFT), sometimes known as a 'Border Adjustment Tax' (BAT).

Read 6.2.1a, 6.2.1.b[1] and 6.2.1c for instructive comment on all these topics.

[1] With apologies for its rotation

2 Tax strategy

The organisation will typically set a Tax Strategy with which the Treasurer should be familiar. The main board will own and be ultimately responsible for the tax affairs and conduct of the organisation. The Tax Strategy therefore will set the tone of tax management within the organisation and its approach to tax risk.

There are various strategic approaches for tax management adopted by organisations of which the following are some of the most common:

- ensuring full compliance with all tax laws globally
- optimisation of a set of key tax performance metrics
- driving a competitive advantage through post-tax enhancement
- resolving all tax disputes and uncertainties in a timely manner
- reducing tax risks

These are not mutually exclusive and most organisations will embrace all of the above and more, but with different priorities according to their risk analysis and scope of opportunity.

Most organisations will employ to some degree 'tax planning' in the management of their tax affairs. It is a well-established principle globally that taxpayers are not required to pay the most amount of tax possible, and may appropriately organise their affairs to reduce that burden. However, the techniques employed to achieve such tax reduction may be closely scrutinised and the Treasurer should be familiar with the concepts and posturing.

It is perhaps firstly worth trying to define some commonly used tax terms in the scope of tax planning. "Tax Evasion" represents the unlawful practice of reducing one's tax burden, and is generally not contemplated by large organisations. Accordingly, they seek to ensure legal compliance and disclose all relevant tax issues, to debate and negotiate on their technical merit. "Tax Avoidance" is the legal practice of reducing one's tax burden. However, in recent times the techniques involved have, in some cases, tended to lack substance causing a raft of anti-avoidance measures by Governments. Whilst in many areas, clever practitioners have sought to continue to avoid the letter of the law, organisations have moved to more robust tax management techniques. In essence, in most cases, a business will seek to manage its tax affairs lawfully, with appropriate substance and aligned to its commercial direction. In fact, in many countries, tax planning is ineffective if not commercially undertaken, motivated by business principles, of which reducing the tax burden may not be one of the main purposes.

Therefore, good tax planning at its basic level can simply comprise ensuring that all tax reliefs and claims to which the organisation is entitled are properly made, or it can move on to structuring commercial transactions such that the tax burden thereon is minimised. In each case, the Treasurer must be alive to the underlying commercial rationale.

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Equally, Governments vie to attract business using their taxation system. Notably, as examples, developing countries have employed tax holidays to attract western companies, whilst developed countries have commonly offered R&D and other technology incentives to hold on to, and attract, intellectual property. The Tax Strategy should align with the position of the business in the economic cycle, the global market and its business strategy.

Tax laws, though, are fundamentally uncertain, and are a good example of political risk. In general, the main rules are enacted in written laws, but these are tested and tried in the courts to supplement and clarify, or sometimes confuse, the precise meaning. Furthermore, in many countries tax law changes each year as part of the annual budget, and changes in tax law can sometimes be retrospective.

Tax risk is the consequence of the organisation:

- interpreting tax laws incorrectly
- implementing schemes incorrectly
- failing to keep good records
- having poor administration
- not dealing properly with complexity (caused by adhering to and managing complex tax laws)
- taking an incorrect ethical stance (where debate can be ill-informed)

Political risk aspects of tax law include:

- changes in tax law
- changes in interpretation of tax law – perhaps as a result of a tax authority challenge
- changes in tax rates (e.g. from 0% to 30%)
- changes in scope of tax law (e.g. a tax now applied to all businesses, not just those with a minimum earnings threshold)

Each of these can ‘wrong-foot’ otherwise sound, legitimate tax planning.

These risks materialize in many ways as set out below:

- financial cost (including interest and penalties)
- reputational damage (where public visibility)
- operational disruption and cost (if assets are sequestered)
- drain on resources (in defending enquiry)

Therefore, it is important that the Board and senior management fully understand these risks. The Tax Director may seek to discuss and disclose the issues early to fiscal authorities to reduce the risks by accelerating agreement. Tax authorities do provide, in some cases, advance rulings or clearances, which can be helpful in these circumstances. If need be, a formal legal opinion can be obtained from an appropriately qualified tax lawyer. In addition, the accounting position will need to be determined as a provision for the tax uncertainties may be required. In some countries, there is considerable disclosure publically of such positions and this likely leads to fiscal authority enquiry.

However, bear in mind that tax is political. Tax authorities can and will challenge tax treatments, despite prior assurances and legal opinions. A notable recent example has been the attack on Vodafone Plc's capital gain on disposal of an investment in India. The transaction was completed outside India, but India claimed tax revenue on the disposal.

Furthermore, tax risks can have knock-on effects in other areas of the business. An overly complicated structure motivated by a perceived tax advantage may cause operational difficulties, and confuse stakeholders' understanding of the corporate purpose and corporate goals. Therefore, it is important that the tax message is clearly delivered. Indeed the treasurer can himself become compromised by actions required for tax purposes and it is important that all risks are brought to the table in considering a particular strategy.

Tax risks can last for many years. Typically, every country will have a statute of limitations to restrict indefinite tax enquiry, although these would normally be lifted for tax fraud. Tax issues can last longer than staff might remain in post and many items in the in-tray of a tax manager are old ones. Therefore, good record keeping is essential.

3 Tax metrics

There are various key tax performance metrics by which analysts and the CFO will measure a company's tax management. The two most common for discussion here are the Effective Tax Rate (ETR) and the Cash Tax Paid (CTP). In addition, there may be "softer" goals such as ensuring the filing of all tax returns by a set date or the resolution of all tax disputes within a set period. However, these can be more difficult to measure with less direct shareholder value linkage and so the more prominent metrics tend to be financial.

CTP is the most precise measure as this is the true cash outflow on taxes. It cannot be adjusted by accounting judgements and therefore appeals to those who prefer cash based financial results. However, it is given to volatility as annual tax payments can vary according to capital expenditure, one-off exceptional deductions or charges, and simply the lag in typically estimating and paying taxes. Furthermore, tax payments may be reduced by items that are charged outside the profit and loss account to reserves or on the balance sheet, delinking the CTP from any clearly disclosed profit level. Therefore, a tax paid rate is rather meaningless as the denominator is not easily attainable. This makes CTP difficult in longer term cash flow forecasting. Finally, the result of any settlement of earlier year's tax audits can distort the current taxes paid.

Under IFRS there is relatively limited disclosure of the composition of CTP. The Treasurer must though clearly understand the timing of tax payments as they can be large and affect free cash flow forecasts.

The ETR is the tax charge as a percentage of profit before tax on recurring/continuing activities. This normally presumes the exclusion of exceptional or one-off items shown by organisations separately in their profit & loss account, although some analysts will still include these items. The tax charge feeds directly into profit after tax and hence earnings per share. A volatile tax charge complicates earnings prediction. However, ETR tends to be

more stable than CTP, as it allows for accounting provisions. The treasurer therefore will typically use ETR in his modelling of cash flows, as an appropriate long-term tax rate.

Most listed groups publish transparent reconciliations of the actual effective tax rate to a benchmark rate, usually the tax rate in the country of parental domicile. For example, see page 126 of the 2015 annual report for Vesuvius plc at:

https://www.vesuvius.com/content/dam/vesuvius/corporate/investors/results-reports-and-presentations/reports/2016/annualreport2015.pdf.downloadasset.pdf
One of the reasons ETR is a good default tax rate in forecasting is that the accounting concept of Deferred Tax allows the ETR to be smoothed, making it reasonably constant.

In essence, the Profit Before Tax (PBT) of a company is adjusted to arrive at taxable income on which the tax rate is then applied to compute the tax liability by adjusting for both permanent items and temporary differences:

- permanent adjustments – those items that are always not taxable or non-deductible for tax purposes
- temporary differences (formerly called timing differences) – those items that are only temporarily non-deductible or not taxable but will be or have been taxed/deducted in another period

The concept of deferred tax (being the tax rate applied to the temporary differences) is that over time the temporary differences will even out and the overall tax charge for a period will be the tax rate applied to the PBT only adjusted by the permanent items. Deferred tax tries to average this rate out to each individual accounting period by placing a deferred tax asset or liability on the balance sheet, which is not a real tax liability but an accounting method to better match the tax charge to the profits in each period.

Example 1: Deferred tax
Take the example of a company with the following results.

	20X0	20X1
Accounting Result		
Income	200	200
Pension cost	50	50
Entertaining cost	10	10
PBT	140	140
Taxable Profit (see below)		
PBT	140	140
Add: Disallowed		
Entertainment	10	10
Add: A/cs Pension Cost	50	50
Less: Pension cash paid	(100)	0
Taxable Profit	100	200
Tax payable at 30%	30	60

The entertaining cost is not tax deductible. The pension cost is tax deductible when paid, and in this case, both amounts of 50 are paid in the 20X0 year. The tax rate is 30%. We can see that on 20X0's profit there is 30 of tax to pay (being 30% of 140 + 10 + 50 - 100). We can see that the on 20X1's profit there is 60 of tax to pay (being 30% of 140 + 10 + 50).

The 30 and 60 are the current tax liabilities. However, we know at the end of 20X0 that the tax computation allowed an extra 50 of pension cost, which actually relates to next year. So, deferred tax accounting requires a deferred tax charge of 30% of 50 = 15 to be made in 20X0 so the total tax charge is 45. This deferred tax liability of 15 is released in 20X1 so the accounting tax charge in 20X1 remains 45. Accordingly, the 30 and 60 current tax charges have been spread out.

The entertaining cost will never be tax deductible and is referred to as a permanent difference because it will always be a difference between accounting and taxable profit. The pension cost adjustment is referred to as a timing difference.

However, today the focus of accounting standards has moved from the profit and loss account to the balance sheet (with the profit and loss account as a balancing number). This change of approach has impacted deferred tax, which is now calculated using the liability method as at the balance sheet date. Thus, the deferred tax provision has moved somewhat from being an effective tax rate smoothing device to a very theoretical indication of how much tax might be due if all the company's assets were sold. The profit and loss account is still largely smoothed to maintain the integrity of the ETR with the balancing adjustments tending to be charged directly to changes in equity. Deferred taxes are recorded at the tax rate that is substantially enacted as at the balance sheet date.

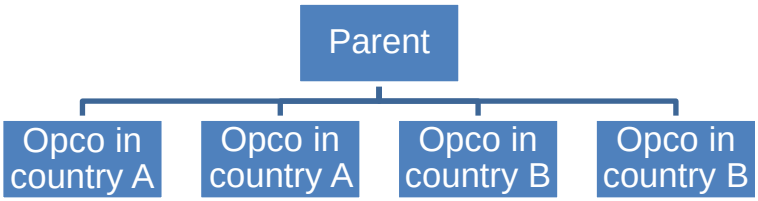
Increasingly, tax systems are converging closer to the accounting position, reducing the temporary differences and hence deferred taxes, although with the notable exception of the US.

Deferred tax can feature in or impact the net worth of an organisation and thus affect performance against maintenance type financial covenants in loan agreements. Therefore, net worth sensitivity to deferred tax movements should be carefully checked before agreeing final wording / definitions.

4 Group structure

Groups are made up of many legal entities (i.e. companies). The tax liabilities discussed to date therefore represent an aggregation of all the companies' tax liabilities. Exhibit 1 shows a simple group structure where the Parent company has directly acquired or established trading companies all around the world.

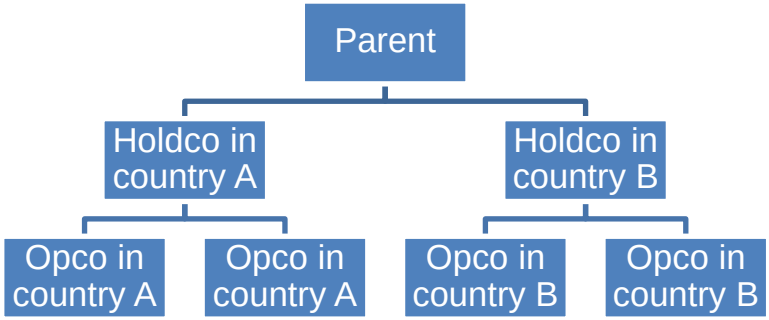
Exhibit 1: Direct holdings



As taxes are levied by a country's legislation, most organisations prefer to have a separate company in each country. There are also broader commercial, legal and accounting reasons, too. This also typically facilitates treasury management. In some small cases, a company may trade in more than one country. If so, each country will have rules as to when the activity in their country becomes sufficient to require taxes to be paid in that country. As a general rule (under typical tax treaties, see later), the concept of Permanent Establishment (PE) defines the tipping point to locally paying taxes. This is a question of fact and normally accords with some form of sustained physical presence, but can also occur where individuals have the authority to contract on behalf of the company in that country. Once a PE is determined, then a tax liability is calculated effectively under a branch accounting approach. There can also be broader local registration, social security and other legal responsibilities causing many organisations to incorporate locally to bring about appropriate financial controls and disciplines over the activities.

Furthermore, many organisations will have different management structures splitting their businesses globally into divisions according to products or markets and this may cause multiple companies in any one country. As a result, there can be the need to establish local holding companies in those countries to obtain certain tax grouping benefits. The inclusion of local holding companies needs careful consideration as it brings about additional bureaucracy and cost and can blur the management reporting lines. Exhibit 2 below shows a typical structure where local holding companies are employed.

Exhibit 2: Country holding companies



There are also variations on these structures, where perhaps a regional holding company may also be inserted into the structure. How the group is actually structured depends on individual circumstances and also the history of a group. An acquisition brings in a new structure, for example and it may take some while to achieve the desired structure.

Some countries allow grouping for tax purposes (or "pools") where losses by one member of the group can be offset against profits of another member. In particular, it is not unusual for the local holding company to take on the debt (intercompany or external) to acquire and fund

its subsidiary operating companies. The interest on this debt is likely to give rise to a loss in the holding company which would need to be offset against the subsidiary operating companies' profits for tax purposes, through such tax pools. Similarly, cash pools may be established for cash management of the local group (see later).

The treasurer is often involved in any re-organisations of, or new acquisitions into, these structures, as intercompany funding may need to follow ownership structure and many liquidity arrangements and their documentation may be based around one design. Particularly if a group has given security over assets and shareholdings, such changes can be very disruptive. The decision surround the capital base of each of the companies in the group is one of the most important that the Taxation Director and Treasurer take together, with appropriate input from other concerned functions, and this is covered in the next section. The intercompany debt and capital of any company in the group is less debated or visible as this eliminates on consolidation, but does have material tax impact. Therefore, it is appropriate to look at some of the key issues surrounding determining the form of the internal capital structure; however, before we do so, we need to understand some fundamental tax principles concerning international capital movements being withholding taxes, tax treaties and double tax relief.

8 Internal capital structure

Fundamentally, the same options apply in setting the capital base of any subsidiary as would apply to the parent company of the group or the group as a whole (as debt can be in a subsidiary). This is a decision on whether to issue equity or secure an intercompany loan. However, for the parent this involves external parties, whereas for a subsidiary it is entirely internal to the group. Thus, for the overall firm decision, different investor considerations apply between equity and debt. For subsidiary capitalisation, arguably intercompany debt has similarities to intercompany equity and the parent is largely indifferent between the two (subject to 100% ownership). Therefore, placing as much debt as possible in high tax countries will reduce the tax burden as we saw in reading 6.1.1. Of course this split is therefore capable of manipulation and so most tax authorities require an adaption of the arm's length standard (as discussed later in Transfer Pricing) to cater for potential abuses in this area. However, where the subsidiary is not wholly owned, then there are a mixture of these internal and external issues to be considered and the extent of the minority holding will have an influence on the capital structure.

While high tax rates are one reason to push debt down into subsidiaries, it is often the case that groups will seek to push as much debt down to the subsidiary companies as possible through intercompany loans even if there is no significant tax shield advantage. These are loans provided to a company in the group by typically a central treasury company acting as effectively an internal bank. Therefore, the operating subsidiary balance sheets will become highly geared. This facilitates cash extraction for the Treasurer as it is generally easier to repay intercompany loans, than arranging for dividends, as there are typically lower withholding taxes (see later) and none of the distributable reserve and legal requirements for dividends. In fact, many cash pooling systems are de facto intercompany lending arrangements (see later). It should be noted that intercompany loans can exist from the subsidiary companies up to the parent or treasury company, but these tend to have greater

tax scrutiny and are often regarded as advances of forthcoming dividends, and should not become long-term.

The key tax advantage to intercompany loans is that it places the associated interest charge in the same company as the operating profits, allowing the two to net when calculating the taxable income and tax charge in the country. (Dividends are not deductible for tax purposes against profits). Therefore, the extent of intercompany loans often depends on the local tax rate: a higher gearing where the tax rate is high affords greater tax relief (as also seen in 6.1.1); whereas, 'tax havens' having relatively low tax rates will typically not have substantial intercompany borrowings and are more likely to be funded by equity.

Example 2: Shifting the tax base

Canny Cars plc operates car dealerships in the UK and USA and owns a company incorporated in the USA (Modern Motors Inc). It requires capital of USD 20 million.

If Canny Cars borrows externally, and lends onto Modern Motors, then it will pay interest on the external loan but charge interest on the intercompany loan. There will be little net interest charge in the UK but there will be an interest charge in the US which will reduce the taxable profits.

If on the other hand Canny Cars had subscribed for additional equity in Modern Motors, the interest deduction would remain in the UK.

This is how intercompany loans can impact the tax base.

However, tax authorities apply a variety of techniques to seek to restrict these interest charges and therefore the erosion of the local tax base, of which the most common are as follows:

- thin capitalisation – arguing that the scale of gearing could not be obtained in a third party case
- interest rates – where they are higher than in a typical third party scenario
- earnings stripping – setting by law of a limit on the amount of interest expense that can be deducted for tax as a percentage of local profits
- interest disallowance – some countries disallow interest in connection with refinancing, or where acquiring non-taxable assets, or a partial/total prohibition
- worldwide debt cap – seeks to ensure that the gearing in the taxable entity is no greater than the worldwide group takes on

Note that the UK has a worldwide debt cap and has proposed an earnings stripping limit as part of its approach to the Base Erosion and Profit Shifting (BEPS) initiative[2]. The US is toying with removing the deduction for interest.

[2] See "**Tax Deductibility of Corporate Interest Expense: consultation on detailed policy design and implementation. A consultation paper issued May 2016 by HM Treasury and HM Revenue & Customs for responses by 4 August 2016"**
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525923/tax_deductibility_s

The Treasurer should be familiar with these restrictions on interest in the group, as this will impact the extent of intercompany lending used. However, there are other commercial requirements in setting the local balance sheet in ensuing local customer/supplier credit, potential exchange control issues, ability to locally service the interest payments, etc. Many of these restrictions apply to both internal and external interest charges.

When setting the terms and interest rates on intercompany loans, the credit strength of the subsidiary company needs to be evaluated as an independent party on an arm's length standalone basis. This would seek to replicate what would happen if the parties were not members of the same group. So, looking again at Canny Cars plc investing in the USA, one would expect a higher interest rate on the loan from Canny Cars plc to Modern Motors Inc than Canny Cars plc pays to the external lender for its credit, assuming similar terms. However, the Treasurer needs to carefully consider the key terms of the intercompany lending, as long-term funding may not be appropriate and care needs to be taken on the currency of the loan, as certainly at one end of the instrument, there will be an exchange exposure for the group. This may eliminate on consolidation, but the local implications need to be considered, including the tax effect of currency fluctuations (see later Hedging). All these terms need to be appropriately documented in an intercompany loan agreement.

The key tax objective for the Treasurer on determining the nature of the intercompany loans to each subsidiary around the world forming their internal capital structure is to ensure that the interest charge is deductible against their operating profits for tax purposes. The next step is to consider where the Holding and Treasury activities reside.

9 Holding company and treasury centre locations

The internal capital structure above comprises either equity which is provided by a sub-holding company or the Parent company; or intercompany loans which are typically provided by the Treasury Centre, although sometimes routed through regional treasuries or local holding companies. These can be one and the same company, but more often than not they are separate activities and companies in the group. Of course, some groups may not well formalise their treasury affairs and not centralise all intercompany loans in a treasury centre, but this is the simplest for tax management and offers the most opportunities. But the principles discussed herein apply whatever the structure.

The previous section discussed the deduction of the interest on intercompany loans in the subsidiary companies as part of the determination of the internal capital structure. It is important now to consider how to manage the returns from the investments in the subsidiaries. In essence, in a simple analysis, the equity investor receives dividends and capital returns; whereas the Treasury company receives interest and a return of capital, possibly subject to foreign exchange fluctuations. Absent FX implications, the return of loan capital generally gives rise to no gain-no loss and therefore is tax neutral. Clearly the

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econd_consultation_v2.pdf plus the response by the ACT dated August 2016
https://www.treasurers.org/ACTmedia/ACT_BEPS_Response_August_2016.pdf

treasury instruments can be more complex, even within a group, by employing deep discount securities, repo transactions, etc. These are often used to replicate third party finance, but more often than not, have a particularly favourable tax result for the group. It is beyond the scope of this analysis to discuss these techniques which are often referred to as "double dips", allowing the same interest to be deducted in two countries (i.e. a double deduction) for tax purposes due to inconsistencies in the different countries' tax laws – effectively the reverse of double taxation (see below).

Therefore, for this analysis, it is assumed that the intercompany loans are 'vanilla' and provided by a Treasury Centre. This allows total management of the loan portfolio, the effective redeployment of the group's financial resources and is an efficient mechanism to manage the tax implications, whereby, certain tax efficiencies are afforded such treasury activities, which is effectively replicating and replacing an external bank. As a result, often the FX risk on intercompany loans will be managed by the Treasury activity, by denominating all such loans in the functional currency of the borrowing subsidiary. These FX exposures can be quite large and need to be carefully examined from an accounting, tax and local aspect.

The Treasury centre manages cash around the group through various mechanisms:

- cash pooling – see below
- intercompany loans – allowing payment of interest and advances/repayment of principal
- equity capital subscription and share repurchases (buy-backs) internally to adjust the subsidiary company's capital base
- dividends – annual or special, subject to legal and accounting restrictions

The location of any sub-holding companies or treasury centres is influenced by a number of factors including availability of talent, local laws, accounting, disclosures, regulations and taxation. From the tax perspective, an ideal location for such investing activities would possess:

- no or low withholding tax on payments out (interest, dividends, etc.) - see below
- a good tax treaty network to ensure minimal withholding taxes on receipts of dividends or interest. see below
- no tax on funds (e.g. interest and dividends) that pass through the company
- no capital, stamp or transfer taxes applying to the introduction of funds as debt or equity and not applying to the sale of investments
- no capital gains tax
- no or limited controlled foreign company rules

In practice, whilst there are many locations which offer a participation exemption for dividend and capital gains, interest will typically be subject to tax. Tax haven locations might offer limited local taxation, but in the absence of a developed tax treaty network, withholding taxes will often apply to the interest payments from subsidiaries to the treasury centre and therefore becomes a high tax cost (see below).

Tax is a major issue in the selection of a treasury centre 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. Such centres usually have practical tax rules designed specifically for financial activities. They will be located in countries with extensive tax treaties and there will be no withholding taxes on interest earned or paid, or income from dividends. These locations should also enable the repatriation of profits without tax deductions. Note, however, that like many business decisions, tax is not the only factor. Issues over staff availability and retention, proximity to management and major investors are equally important factors.

10 Capital taxes

Most of the discussion to date has been in connection with income taxes. Clearly an important factor in holding company locations is the implication of capital taxes. Increasingly, countries are starting to employ broad participation exemptions that not only apply to exempt dividends from taxation but also capital gains as a form of incentive to investment and entrepreneurship. This therefore, makes for an ideal holding company location if that was the end of it. However, at the same time, such locations also typically have interest streaming rules which disallow any interest related to those participations. So one cannot have one's cake and eat it! With perhaps the exception of the UK currently (but only just currently)!

Let's first define a capital transaction. This is a sale of a capital asset (equities, goodwill, intellectual property, real property, potentially debt instruments, etc.). Capital assets are typically defined as assets used in the trade or investment, which are not given to recycling or regular sale or trade. Such a capital sale can also occur on an internal reorganisation within a country, or moving business to another country, both transactions being wholly within the group and therefore not giving rise to any group consolidated gains. However, looking narrowly to an individual country or a company, if it has released a capital asset then a capital transaction has occurred.

So, starting with the basics, ideally we would like all such capital transactions to be exempt from tax. Often, we can fall within stated statutory exemptions, although the Tax Director will normally, if possible, seek formal clearance of such exemption from the local tax authorities and this may become a condition to the transaction. Such clearances are important, as the tax costs otherwise can be quite material.

If the transaction is not exempt from tax, then the first step is to identify the tax base. This is often quite hard because of the long historical evidence required and is subject to the quality of the tax reporting and documentation. Treasury transactions can be regarded as capital events augmenting the tax base or dividend strips regarded as reducing the tax base. Indeed, the outside tax basis of the company (i.e. the acquired shares) may be different to the inside tax basis (sum of tax values of the assets of the company), giving rise to different tax consequences from selling shares or selling assets. Although beyond the scope of this reading, the Treasurer should be aware that there are significant differences to a buyer and seller between an asset or a share transaction. Accordingly, a seller may undertake considerable pre-sale reorganisations within the group, to set up the optimum sale

transaction structure. The Treasurer will be key for ensuring the value is in the right place and that the cash flows accord with the reorganisation's objectives.

Internal reorganisations may need consents from external lenders, as any tax cost would represent an exit of value from the company. In addition, tax liabilities on such internal reorganisations may be deferred until some ultimate external sale. This gives rise to a tax cost to that final external sale, which may prohibit a future exit strategy, possibly acting as a poison pill! Therefore, all investors are normally very interested in any significant internal reorganisation to ensure that it will not adversely affect their objectives to realise future value.

Having said the above, in most countries there are internal reorganisation reliefs to permit share mergers, demergers, internal transfers of business or shares, provided typically, that there is strong commercial purpose.

The company often has considerable opportunity to organise its sale structure optimally to significantly reduce the impact of capital taxes on an external sale. We have mentioned above that there are considerable tax differences between selling assets or shares, together with broader commercial considerations. At the same time the buyer will be seeking an optimum acquiring structure and ensuring that he maximises his tax base, optimises the global mix of profits and utilises all available tax assets & credits promptly. The final negotiated transaction structure needs to be laid out clearly in the Sale & Purchase Agreement and supported by the cash flows. This tends to be a key area where tax and treasury work closely together and can drive real shareholder value.

11 Transfer pricing and the Arm's Length Principle

Transfer pricing describes the issues surrounding decisions about where the profits and hence tax arise in multinational groups, although domestic transfer pricing is now also an issue. Transfer pricing applies to both commercial and capital transactions, and is continually rated in the top three international tax issues. Most countries have enacted transfer pricing rules to enforce adequate taxable earnings in their own jurisdiction, and they police them vigorously. The fundamental principle called the arm's length standard is that 'related parties' such as companies under the same ownership should trade with each other on terms and pricing similar to what might be expected to apply had the transactions been between unrelated parties (i.e. on an arm's length). If related parties fail to do so, then tax authorities may deem a value for such transactions in their jurisdiction. This standard attempts to prevent multinational groups inappropriately skewing profits to lower taxed jurisdictions and eroding the tax base of others.

However, there is still considerable scope for organisations to manage their supply chains tax efficiently. This is usually achieved through a trading model (both with third parties and within a group) that genuinely allocates profit according to the location of functions, human, tangible and intangible capital, and risk. An example would be the replacement of local distributors with local commission agents who take little risk (and so receive little reward), or engaging contract manufacturers that earn a low but fixed return.

Companies are normally required to have contemporaneous documentation in place to support the transfer pricing system used. Failure to produce this documentation will reverse the burden of proof and as a result, an intention to shift profits abroad may be deemed present unless proven differently.

Transfer pricing is a major issue for corporate treasuries because of their heavy involvement in intercompany transactions, for which they usually wish to charge and must do so on an arm's length basis. In the field of financial transactions, areas such as interest rates, foreign exchange spreads, guarantee charges and fees for the various transactions are all subject to arm's length pricing requirements. In-house re-invoicing and factoring centres usually receive particular scrutiny from the tax authorities of all countries where participating group members are based. Also, where an in-house treasury vehicle is based in a jurisdiction that is a recognised tax haven, tax authorities become especially vigilant and require proof of market pricing. This can raise issues for the treasurer seeking to deploy group-wide services such as via an in-house bank. If arms-length pricing is strictly enforced, then there will be little or no financial incentive for subsidiaries to deal internally rather than externally, and other motivations will have to be sought instead.

Example 3: Transfer Pricing: Intercompany loan

Orange Co is domiciled in Orangeland, which taxes corporate income at 35%. Orangeco has a subsidiary, Blueco, which is domiciled in Blueland. Blueland taxes corporate income at 50%. Both countries use currencies pegged to USD.

Suppose Orangeco currently makes taxable profit of $100m a year, and Blueco makes $50m.

Orangeco wishes to gear up Blueco, so that loan interest reduces Blueco's taxable profit. Orangeco can borrow USD at 2%; Blueco can borrow USD on the same terms locally at 2.5% on a standalone basis.

In group terms it is more efficient for Orangeco to borrow and lend the funds on to Blueco. However, Orangeco wants to make a turn on the arrangement, and to take advantage of Orangeland's relatively lower tax rate. So Orangeco borrows USD50m at 2% and lends the funds on to Blueco at 5%.

The net effect is that Orangeco earns 3% x $50m = $1.5m pa pre-tax on the arrangement; while the cost to Blueco is $2.5m pre-tax. So far so good.
However, Blueland's tax authority are likely to challenge the terms of the loan, and may disallow the excess 5% - 2.5% = 2.5% loan cost for tax purposes. Orangeland's tax authority will do nothing – the arrangement earns them extra.

So Blueco will pay tax of 50% x $(50 – (0.025 x 50)m = $24.375
The ETR is 24.375 / (50 – 2.5)m = 51.3%

The example illustrates a key concept in transfer pricing – fiscal attack is usually asymmetric, and only tax authorities perceiving excess tax deductions will raise the issue.

It is important that the basis of pricing financial transactions is not only at market prices (including margin where appropriate), but that there is independent documentation in place to support the prices used. 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 used. Justification of margin can be more subjective due to the difficulty of finding published values for similar credits. Possible comparators might be alternative facilities offered by banks locally or perhaps bond spreads. However, such prices should be based on a standalone assessment of the creditworthiness of the local borrower and this can be very difficult to assess, especially if the parental connection is crucial to trading. The treasurer can only produce reasonable evidence here.

Where there is a central treasury operation or an in-house bank, pricing arrangements should be formalised in the same manner that they would be with an external commercial bank. Therefore, loan agreements stating borrowing rates and other terms and conditions should be signed between parties and spreads agreed for taking deposits or buying or selling currencies. Fees for services such as netting, re-invoicing or factoring must be fully documented.

The same applies where a parent company is obliged to guarantee a subsidiary as a means of securing the subsidiary a lower borrowing rate. In this instance, the parent should charge the subsidiary for the value of the guarantee. If the “guarantee” is merely for bank comfort (i.e. does not place an obligation on the issuer, an instrument called a ‘letter of comfort’), and does not enable cheaper financing, then the parent does not need to charge.

Care must also be taken on the reasons for business changes of all kinds as step adjustments can create tax exposures in themselves.

Example 4: Disposal
Muppet SpA has manufactured industrial goods in Italy for many years and also operated its research and development and marketing from the same site. The shift to cheap manufacturing has led Muppet to review this strategy and has led to a change. Manufacturing is now located in Asia, but research and development and marketing remains in Italy. The tax authorities could view this change as a disposal in that a profit stream has left the country, comprising the goodwill and intangible expertise in operating the factory, together with machinery and tooling and dies. Accordingly, this is deemed a disposal on which there are capital tax consequences.

Example 5: Disposal
Still Waters GmbH made a fixed rate loan to its US subsidiary, River Rapids Inc at a rate of 8% prior to the credit crunch. Following the credit crunch inspired recession, profitability has fallen at River Rapids so that it is making tax losses and cannot take advantage of the tax deduction on the interest. Still Waters proposes to switch the loan to floating rate, which is lower, to allow full relief.

The German tax authorities could consider that such a change should be accompanied by a break fee and assess the taxes accordingly.

Structures such as “shared service centres” where a centralised group resource provides services to affiliates also attract particular attention from tax authorities. Again, the arm’s length rule must be applied, and the pricing and service levels must be fully documented and close to those that might be offered by a third party provider.

12 Controlled foreign companies

Setting up a foreign company in a favourable tax location is a popular technique for avoiding domestic taxation. Most countries have controlled foreign company (CFC) rules that allow them to attack foreign companies that are controlled from the home country but subject to lower tax rates. Usually, profits of a subsidiary are taxed when they are distributed or repatriated, but CFC rules state that under certain circumstances ‘passive income’[3] (which may include income from intercompany lending activities) may be subject to tax immediately.

The U.S. has similar regulations called Subpart F legislation, which provides for the taxation of foreign-sourced income whether or not it is repatriated. In the case of the US, however, there is an exception for income earned in the active conduct of an insurance business or of a banking, financing or similar business (so-called “active financing income”) from Subpart F income.

This can become an issue if a tax pool has been established in a low tax country and the foreign parent is in a high tax country. Net interest income earned, (which is classified as passive income), may be recognised immediately and taxed at the shareholder level.

Companies with genuine operations and substance in the foreign country should not be caught by such rules, but care should be taken when evaluating special purpose vehicles such as debt issuers, shared service centres or finance/treasury companies.

Taxation of overseas subsidiaries is a rich vein for governments seeking to widen the tax burden and finance their spending plans. However, it can also be a deterrent to establishing groups in a country and therefore governments seek to balance their protection of the Exchequer with a reasonably attractive international tax regime. As an example, the initial approaches to revising this area taken by the UK Treasury in recent years caused a number of companies to emigrate (move their residence out of the UK) and the adverse publicity caused the UK Government to amend its plans. The new proposals indicate an acceptance of an offshore treasury operation subject to tax at an effective rate of a quarter of the UK mainstream Corporate Tax rate.

13 Tax implications of pooling and concentration of liquidity

Liquidity management techniques (including cross border arrangements) have become very popular, especially in Europe but are found increasingly globally. The following summarises

[3] Passive income is income (such as investment income) that does not come from active participation in a business.

the major tax and regulatory issues brought about by cash concentration and notional pooling.

13.1 Notional pooling

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

- It 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 and legal right of offset to secure the position of creditors 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 capitalisation ratios
- Legal constraints, such as not allowing cross-border legal right of offset, prohibiting the co-mingling of resident and non-resident accounts or requiring central bank reporting and reserves to be maintained on a gross basis render pooling unviable or difficult in some countries

13.2 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 treated for tax accordingly.
- No cross-guarantees or legal right of offset are required (except possibly to cover for 'daylight' risk).
- 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 capitalisation is likely to be an issue.
- May attract deemed dividends.
- In some countries there may be additional stamp duties on cross-border intercompany loans (e.g. 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.

Location of cash pools may invoke CFC rules.

14 Withholding taxes

Firstly, let's discuss withholding taxes and start with their impact on the movement of funds and capital across borders. We have discussed above how governments may deny the deduction of expenses (interest, etc.) to prevent the erosion of the tax base. However, even where the deduction of such expenses is acceptable within local laws, countries may dislike their payment offshore (particularly to low tax havens) and therefore generally provide for the requirement for the payer to withhold taxes from such payments. As you will see later, tax treaties will, in part, seek to define the rights of governments to apply such withholding taxes and, if not provided by local domestic laws of the receiving territory, permit double tax relief to avoid the same income being taxed twice, in two different jurisdictions.

Therefore, a withholding tax (WHT) is a tax deducted at source on earnings, including employment income, dividends, interest payments, and can also include intangible services. Because WHT is a charge on earnings, 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 withholding is withheld by the remitter and 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 for the reduced rate to apply. As there are considerable differences between WHT rules, companies need to carry out due diligence at the country level first and then look at the tax treaties that are available to it in order to obtain a full appreciation of the impact of WHT on their activities.

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

- dividends and royalties
- bank interest applied at source
- interest paid to non banks or foreign banks inside syndicated loan agreements
- deemed bank interest applied by the corporate treasury
- interest on intercompany loans applied by the corporate treasury
- payments considered 'in lieu of interest' such as guarantee and arrangement fees

WHT on dividends and royalties

WHT is deducted from the gross dividend or royalty payment and the net amount paid to the investor/beneficiary. The tax is paid directly to the taxing authority.

Example 6: WHT on dividends or royalties

Blueco from Example XX above declares a dividend of $10m to Orangeco. Blueland imputes withholding tax of 5% on dividends paid.

So of the $10m dividend declared, Blueco pays $500k to Blueland's tax authority, and the remaining $9,500k to Orangeco.

WHT on bank interest

Both notional pooling and cash concentration can be impacted by WHT on bank interest. WHT is often deducted by banks at source from interest paid to depositors, and so the banks have use of the WHT amounts until they are paid over to the relevant tax authority. The company may, or may not be able to reclaim or deduct the WHT from income when the corporate tax return is filed. It will depend on the tax treaties in place for the countries involved.

Example 7: WHT on bank interest perhaps with complexity of gross up clause
Blueland also applies a 20% withholding on loan interest, including that on intercompany loans. The intercompany loan between Orageco and Blueco includes a gross up clause.

The effect of the gross-up clause is that Orangeco requires Blueco to adjust its interest payment so that Orangeco still gets $2.5m cash in hand each year.

So Blueco has to pay a total of $2.5 / (1-0.2) = $3.125m of interest cost to Blueco.

Of this, 0.20 x $3.125 = 0.625m is paid to Blueland's tax authority on behalf of Orangeco, and 0.80 x $3.125 = 2.5000m is paid to Orangeco.

So, although WHT is a tax on the recipient, the effect of a gross up clause is to make it also an additional cost to the payer.

WHT may also be deducted by the corporate treasury when doing interest reallocation on deemed bank interest arising from a notional pool.

In some countries, such as the UK 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 centres. However, if affiliates are participating in the pool that would normally be subject to WHT in their country of domicile, the corporate treasury has to withhold the tax before paying interest to these affiliates. In this case, the corporate (treasury) has use of the funds until they are paid over to the tax authorities.

WHT on intercompany loans
Cash concentration is further impacted by WHT as the sweep creates intercompany loans. In some countries a WHT or stamp duty must be paid on cross-border or even certain domestic loans which make this type of funding unattractive.

WHT on payments 'in lieu'
Some countries levy a WHT on value that has been provided, such as issuing a guarantee or an arrangement fee. The tax is due irrespective of whether or not an actual payment was received or charge made for the service. In order to avoid being taxed on the default level of deemed income, the treasurer should ensure that such arrangements are properly documented so as to minimise the tax burden. (See 'Transfer pricing' below.)

Residency issues

In some countries (such as the UK and France) the rules relating to whether WHT is deducted are different for residents and non-residents. For example, in Germany WHT is levied at a rate of 30% on interest paid on resident bank accounts, but not on non-resident accounts. Documentation needs to be provided to the taxing authority justifying exemption from the WHT.

Calculation of WHT due

With cash pooling, the onus is on the borrower (i.e. interest payer) to determine the amount of WHT due and to pay it to the appropriate tax authority. The company, therefore, needs to ensure that it has adequate systems and tracking mechanisms to capture the data and perform the calculations. For treasurers who centralise liquidity and therefore have many intercompany loans, this can become quite a burden because each counterparty country is likely to have different approaches to the issue.

WHT rate

The amount deducted by the payer and paid over to the local tax authority may, in some cases, be reduced under the provisions of double tax treaties between the payer's and the recipient's countries of residence. See Tax Treaties below.

Tax credit or refund

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.

Conclusions

WHT can be very expensive in a group setting. If the income would otherwise be exempt from tax in the receiving country (such as foreign dividends received in the UK), then the WHT is an absolute cost – there is no local tax to offset. Equally, if the WHT applies to payments made to a low-tax country or tax free zone, then again the WHT is a direct tax cost.

Also, governments have a habit of switching withholding taxes on or off – changing rates or scope from budget year to budget year.

The expense of WHT, the search for stable treatment, and the extent of double taxation treaties all greatly influences the choice of location for holding and treasury companies.

15 Tax treaties

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. They are designed to facilitate international trade by avoiding double taxation where each country will seek to tax the same income or company. Since each country negotiates its own treaties bilaterally there are a great number of treaties and the issue can become quite complex. Sometimes this results in no, or lower, taxes being paid in the home country. In order to apply the treaty rate, a company will usually have to seek prior approval from the tax authorities in each country before making remittances. It is important,

when selecting a treasury centre location, for example, to seek a location with a broad range of tax treaties.

Tax treaties can significantly reduce the level of WHT that can be levied by one country on payments to another country. Tax treaties never impose taxes, they only limit their levels to a typically more favourable position in recognition of the accord between the two countries.

In addition, for members of the European Economic Area, there are Tax Directives which have binding effect, or require enactments within each member state. These can provide relief from withholding taxes, facilitate cross-border mergers or provide for effective arbitration on double tax issues within the European community. Furthermore, the European Court of Justice seeks to ensure commitment by the member states in their tax laws to the principles of the European Economic Union and is the final arbiter on appeals by taxpayers on such points of law.

Many re-organisations such as subsidiary capitalisations, change of ownership or dividend declarations are quite sensitive to tax treaties and some transactions are often delayed pending the signing of a new treaty or final decisions on European Court cases.

16 Double tax relief

When a company receives income from overseas that has been taxed at the local level, there can be instances where it is again taxed at the domestic level. A simple example is where a withholding tax, of say 30%, applies to an interest payment from one country and then this receipt in the other country is also subject to tax, say at 25% on its gross amount, resulting in a total tax burden of 55% on the income. This causes double taxation and becomes a material disincentive to international trade. There are four options in dealing with the potential for double taxation, in order of most advantageous to the company:

a) The tax treaty may provide for exemption from withholding taxes by the payer, typically provided that the level of investment by the recipient in the payer exceeds certain thresholds;
b) The tax treaty may call for participation exemption (which prevents the same income from being taxed twice) or similar provisions may be embodied in the domestic tax laws of the recipient country, whereby the income may not be taxed again at the shareholder level
c) The overseas tax may be 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
d) The overseas tax may simply be allowed as a tax deduction against the domestic tax liability, i.e. the tax paid overseas is used as a deduction against domestic income, reducing taxable income

17 Hedging

Hedging is worthy of special mention and is an example of the pitfalls of the “entity by entity” approach to tax. Firstly, the taxation of foreign exchange and derivatives is a highly specialised area. Tax law struggles to keep pace with the increasing complexity of derivatives and the changes in accounting. This combination of complex instruments, complex accounting, complex tax law, often multi-jurisdiction, and rapid change means this area needs careful consideration.

In particular, the hedging of intercompany loans provides certain complexities. The accounting position on consolidation should be confirmed but this often eliminates any impact from fluctuations in the exchange rates on the principal balances of intercompany loans. However, the local tax position may be not be neutral and a large currency swing may give rise to a large tax payment, which would be undesirable.

It is worth taking advice for any material forward foreign exchange transaction, any swap (interest or currency), any option and any more esoteric derivative, to gain confidence that it gives the expected result on a post-tax basis. It is all too easy to have the underlying transaction in one entity and the hedge in another, and thus be hedged economically as a group, but find that for group accounting or tax purposes the hedge is inefficient. A basic rule is therefore that any derivatives should be in the same entity in which the underlying risk that is being protected actually arises. This can of course be achieved with intercompany derivatives so that central dealing can be carried out in a centralised treasury. Portfolio hedging might then be a difficult concept to square with tax, or indeed any situation where hedging is separate from the commercial books.

Hedging is also important to ensure that currency movements do not adversely impact distributable profits, either at a subsidiary level, or at the parent level. The Treasurer is often overseeing the organisation’s capability to satisfy its distribution requirements and will monitor the flow of dividends and qualifying consideration up from the subsidiaries to provide adequate resources and reserves for the Parent company to satisfy its shareholders. In recent years, organisations have had to undertake restructuring of their top company structure to free up distributable reserves. This is a critical area for the Treasurer to monitor.

18 The future of tax

We look at the BEPS project and recent proposals in the United States.

18.1 Base Erosion and Profit Shifting

The BEPS project is the culmination of an OECD project, endorsed by the G20, to identify ways to amend international rules in order to tackle Base Erosion and Profit Shifting. The project reached a significant stage in November 2015 with the approval by G20 leaders of a complete package of OECD recommendations addressing 15 areas (or Actions). The recommendations contemplate far-reaching international tax reforms, which can broadly be divided into three areas or objectives:

- proposals that seek to ensure that taxable profits are more closely aligned with operational substance;

- proposals aimed at restricting techniques, such as intra-group debt and 'hybrid instruments', intended to generate excessive reliefs in high-tax jurisdictions (not matched by tax on the corresponding income); and
- proposals to increase transparency of cross-border tax structures and the sharing of information between tax authorities.

Domestic implementation of the proposals should now follow in many countries, although the timing and extent of adoption will vary per country, and OECD work continues on a number of matters, including a proposed multilateral instrument to modify bilateral double tax treaties. The UK is a keen supporter. This is a major change for corporations as some of the funding arrangements that have been used by UK multinationals for investing overseas, including into the US, will cease to be effective and internal reorganisations may be appropriate.

The major actions relevant here are as follows[4] (this is a high level simplified summary and should not be used without advice):

Exhibit 3: BEPS Action points

Action	Title	Description
2	Hybrid mismatch arrangements	This is around instruments which are taxed differently in different jurisdictions, allowing double dipping.
3	Controlled foreign companies	The UK already has quite strong laws in this area.
4	Interest limitations	This is a major action of the project in the UK. To restrict relief for a group's overall UK net interest expenses by reference to a fixed ratio, being 30% of UK EBITDA, subject to the alternative of a worldwide group ratio test applied locally if that leads to a better result for the taxpayer (based on the overall group borrowing position, using a net interest to EBITDA ratio for the worldwide group). Infrastructure projects should escape the limitation. This will replace the existing UK worldwide debt cap regime
5	Harmful tax practices	This is about what has been preferential intellectual property regimes in particular, including the UK's 'patent box', which enables certain IP-related income to be taxed at a privileged low tax rate (of 10%). The UK regime needs to change, such that access to it is only available where the related R&D activity is located here.
6	Treaty abuse	This is around planning to take advantage of double tax treaties.
7	Permanent establishments	it has become too straightforward to derive revenues from a country without a taxable presence there, including by the use of agency or near agency arrangements or by relying on specific let outs for activities hitherto regarded as This action should make this more difficult.

[4] For further details see 6.2.1d - Freshfields briefing paper

8 to 10	Transfer pricing	These actions are designed to ensure, when allocating profit on an arm's length basis between entities, a greater focus on true value creation, underlying substance, control of (and financial capacity to control) risk, and actual decision making.
13	Transfer pricing documentation/country-by-country reporting	This action contemplates documentation requirements involving master files, local files and country-by-country reporting that will provide breakdowns to tax authorities by reference to activities carried on, revenue, profits, tax paid and accrued, employees, capital and tangible assets.

18.2 Border Adjustment Tax

In the United States, Republican members of the House of Representatives have proposed replacing the US Federal corporate income tax with a "destination-based cash-flow tax" (DBCFT) - sometimes referred to as a "border adjustment tax" (BAT). The intention is to reform US corporate tax system so it applies on a territorial basis, rather than worldwide, reduce the rate from 35% to 20%, and close down opportunities for avoidance.

An important feature of the DBCFT is that it is "border adjusted" – it taxes domestic sales of goods/services but exempts exports; it gives a tax deduction for goods/services acquired domestically but not for imports.

Two features of this proposal are particularly relevant for treasurers. Firstly, the interest deduction is ended and secondly all domestic expenditure, including capital, is allowable immediately. Recall Modigliani and Miller (without tax), where there is no uplift in value from financing decisions and this makes this really significant. While this may never happen, it does point to the continuing threats to the safe and secure world that treasurers have got used to over many years.

See 6.2.1e Clifford Chance briefing infographic for more details.