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Part One of Two

Notional vs. Physical Cash Pooling Revisited

By Susan Hillman, Treasury Alliance Group LLC

More and more multinationals are opting for cash pooling to effectively manage global liquidity, simplify bank account structures and reduce overall bank transaction costs. Here's what to know before starting a global cash pool.

Cash pooling has enjoyed renewed interest over the past few years as the financial crisis has raised many firms' interest in maximizing the availability of internal sources of capital. This very useful cash management strategy, particularly when executed on a global scale, is a proven method of effectively making more cash available while simplifying bank account structures and reducing overall bank transaction costs.

Any multinational company looking to embark on an international cash pooling project should start with a basic understanding of a typical cash pooling arrangement and then consider organizational, tax, regulatory and banking issues critical to a successful implementation (a subject for part 2).

Pooling is usually accomplished through an arranged bank account structure that mimics corporate accounting treatment and offsets cash deficits with cash surpluses between different legal entities in a corporate group. There are generally two types of pooling arrangements, notional pooling and physical pooling.

NOTIONAL POOLING

Notional pooling refers to the offset of interest income and expense (credit and debit interest), resulting from the varying cash positions in separate bank accounts held at the same bank. Each company participating in the pool maintains its own accounts. The bank then creates a shadow or notional position from all of the participant accounts reflecting the consolidated cash position on which interest is paid or charged.

Notional pooling is not permitted in all countries, notably the US and Germany, where tax authorities consider it to be a co-mingling of funds.

Because there is no movement of funds involved, the pooling is referred to as notional and the legal and tax separation of the pool participants—who ultimately share a common parent—is maintained. There is no co-mingling of funds although some local tax authorities may interpret this differently. Using a single currency example, the results of notional pooling are seen in the chart below.

Because of its simplicity and ease of operation, notional pooling is the technique of choice for single currency pools within a particular country where there are varying cash positions; that is, if notional pooling is allowed.

Notional pooling is not permitted in all countries, notably the US and Germany, where tax authorities consider it to be a co-mingling of funds.

Countries where notional pooling is most common such as the UK, Netherlands and Belgium, have minimal or no withholding tax on interest, but there may be country-specific interpretations that require a holding company to function as the pool manager – such as France, for example.

■ **Right of offset (are guarantees needed?)** Where allowed, central Bank regulations will dictate how the pooling bank, as the service provider, accounts for this arrangement on its balance sheet. For example, in many of the countries where notional pooling is permitted, the relevant central bank requires that the bank performing the pooling have cross guarantees between participants in the pool. The logic behind this is that deficit balances from pooling participants appear as assets on the bank's balance sheet. Since the bank does not earn interest on these assets because of the notional offset with participant surpluses, they could be considered non-performing loans unless the bank has a clear right of offset.

The guarantees enable the banks to prove the right of offset, or the right to use surplus funds to cover deficit positions. However, this cross guarantee requirement does not apply in the Netherlands, hence the popularity of the Netherlands as a location for notional pooling.

Notional pooling takes on more complexity when it expands from a single country to multiple-country arrangement. This is due to both the cross-currency and cross-regulatory nature of the pool.

■ **Currency conversion.** When dealing with more than one currency, it is necessary to bring the currencies to a common base currency, usually the Euro or US dollar, before the pooling and interest offset can take place. This is done in one of two ways:

1) **Short-dated swaps:** one currency is swapped for another at a specified rate. This arrangement can easily be handled internally as the company can execute the swap transaction and thus have better control—or at least transparency—of both FX and interest rates. However, the internal management of this process becomes somewhat unwieldy from an administrative perspective if there are more than three or four currencies involved.

2) **Notional conversion to a base currency** with the risk covered through the adjustment of the interest rates paid or charged in each currency.

Either approach from a bank's perspective may make the process more problematic and less cost effective as the bank's desire to be compensated for its risk takes place at the expense of the corporate pooling its funds. Usually fees will be assessed to cover cost and provide profit incentive to the bank. In cases where cost or jurisdictional prohibitions limit notional pooling, multinationals turn to physical pooling.

PHYSICAL POOLING

Physical pooling is also referred to as zero balancing. It can be achieved on both a single-country and cross-border basis, but only for a single currency at a time. As with notional pooling, each company division or subsidiary maintains its own bank accounts, which are normally sub-accounts linked to a main or header account (see chart below). These accounts can be held in any location, assuming there is no regulatory restriction.

Each division or subsidiary conducts its commercial operations, paying and receiving money, ideally through these sub-accounts held with the pooling bank. At the close of each business day, the net funds positions in these accounts are physically transferred to the main account. Usually the main account is maintained in the name of another legal entity, such as the parent, a regional subsidiary, or a finance company: whatever is best from both a practical and tax perspective.

When dealing with more than one currency, it is necessary to bring them to a common base currency.

From there, the net position in the main account is either invested, if there is excess cash, or funded through a centralized credit facility. The movements of money to and from divisional or subsidiary accounts are generally treated as intercompany loans unless all movements take place within the same legal entity.

Whether the physical pooling takes place within a single country or cross-border, the issues of concern are the cut-off times for transactions, the actual cost of the transaction and the ability of the company to handle the intercompany loans associated with the pooling.

Since the physical pooling typically takes place within the same banking network, the transfers are then book transfers, so the transaction fees are typically lower than those levied on transfers through a clearing system.

The bank essentially substitutes its DDA system for costly and inconvenient local or cross-border transfers through national and cross-border clearing systems. Banks able to do this may waive the book transfer change and assess fees based on a monthly pooling charge or by the number of accounts included in the pooling arrangement.

■ **FX issues.** Because there is a physical movement of funds, this type of pooling on a cross border basis is not possible where FX regulations prohibit the unrestricted cross-border movement of funds, as is the case in Brazil, China, India and Korea.

Even if the FX flows are allowed, they may not be cost effective. For example, in Mexico, there are significant withholding tax implications relating to parent/subsidiary intercompany loans that make cross border physical pooling impractical and costly.

Once the funds are in the central location, the company can choose to have interest paid on each currency pool or may elect for the bank to notionally pool the separate header accounts to achieve interest maximization.

More proactive treasuries will manage the excess cash positions themselves and determine whether to invest by currency or enter into short dated swaps in order to achieve the notional pool interest effect.

Cash to intercompany loan balances. The impact on each pool sub-participant's financials is as follows: what may have been excess cash is now characterized as a loan to the Holding Company. The funds will remain as an asset on the subsidiaries' balance sheets, but restated as a note receivable.

If desired, a footnote can be made on the balance sheet regarding the arrangement. Pooling in this way does not impact capital structure or create any impression of thin capitalization.

The process works in reverse as well: if a shortfall position arises for a few days or weeks during normal business cycle fluctuations, the net deficit amount in the subsidiaries' sub account will be funded by a sweep from the pool. This is also treated as an intercompany loan and the subsidiary will be charged interest by the Holding Company.

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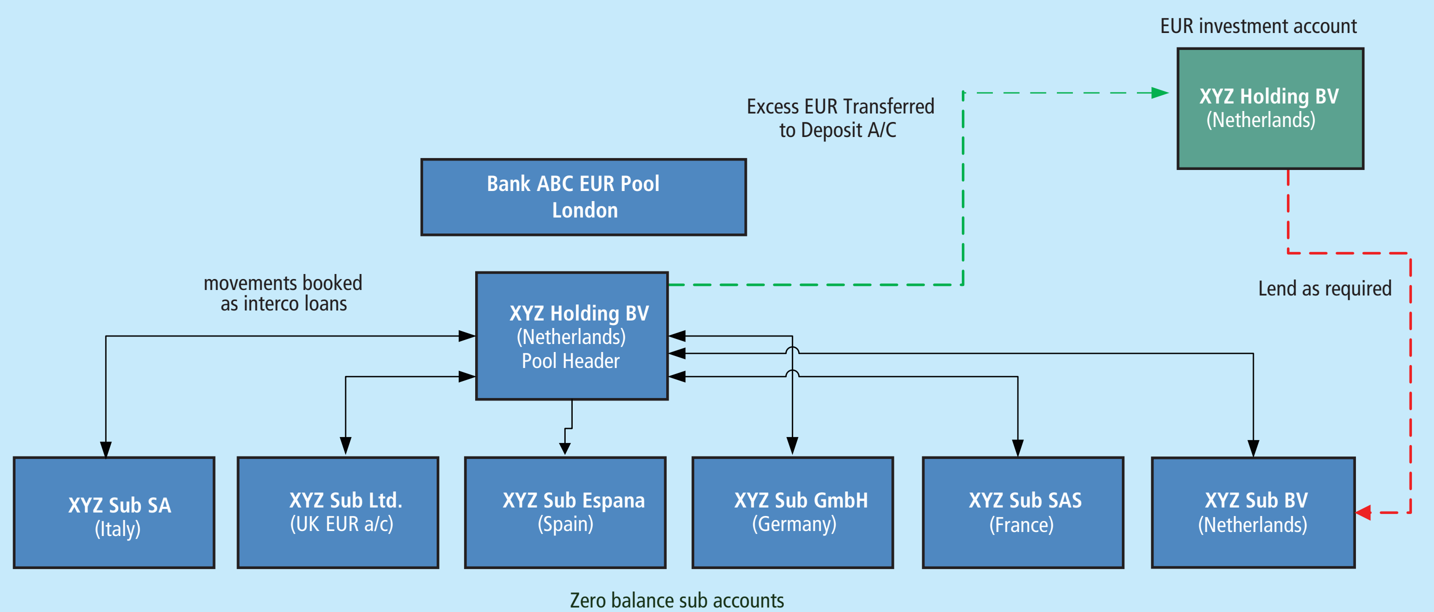
EXAMPLE — EUR PHYSICAL POOL



Source: Treasury Alliance Group LLC

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Part two of two

Further Considerations on Cash Pooling

By Susan Hillman, Treasury Alliance Group LLC

Tax, interest and regulatory considerations are key parts of most liquidity management implementations.

In Part One, the basics of pooling—both notional and physical—were discussed. Part Two digs a bit deeper into the tax, regulatory and related considerations involved in setting up cash pooling, some of which, were raised already. The appropriate pooling structure can only be determined after thinking through all practical and jurisdictional issues that may arise.

KEY CONSIDERATIONS

In evaluating pooling arrangements, consider the following questions:

■ **What about tax?** As alluded to in Part One, it is essential for firms to structure and document their cash pools in order to avoid any appearance of commingling of funds or deemed dividends, which may be subject to the interpretation of local tax authorities in each jurisdiction involved in the pool.

Notional pooling requires cross guarantees, but with physical pooling, the nature of the underlying transactions are clearly defined as intercompany loans. Thus, this cleaner and more transparent treatment can be preferable from a tax perspective. But as with all intercompany loans, documentation of arm's length interest is essential.

■ **Interest calculations?** On a monthly, quarterly, or annual basis, the interest income and expense will need to be calculated and allocated to the subsidiaries. Most companies with simple transaction flows use a spreadsheet to track the loans and interest. This activity takes a few minutes a day and a couple of hours at month end.

A treasury management system (TMS) can be used for those multinationals with complex flows and/or multiple participants.

For tax reporting purposes, the interest statement is provided to the subsidiaries—usually a standard report that can be generated from the ERP system. Alternately, a third party TMS application or the ERP's treasury module can be used.

■ **What type of interest?** This underscores the importance of the definition of interest as a key determination of tax treatment. The type of interest will affect the allocation back to the participants and the taxation levied on them in their own tax jurisdiction. For most companies operating a physical pool, the main account holder acts as an agent so, when the transactions are set up as intercompany loans, the interest is treated as bank interest which does not attract withholding tax.

Rates paid/charged will be based on LIBOR or EONIA—which is a standard benchmark rate. Whatever strategy is selected for cash pooling, both local and corporate tax counsel need to review and sign off on the arrangement.

■ **What's the intercompany loan arrangement?** The structure of the intercompany loan agreements in a cash pool is fairly straightforward. The company can elaborate or enhance its basic intercompany loan agreement to meet specific internal requirements, including notes or caveats that the loans are 'payable on demand' or any such language that provides both the corporate parent and the business operations with a level of comfort.

However, most companies choose to make the language and documentation as simple and straightforward as possible—particularly because the relationships are intercompany and not between third parties.

■ **Who owns the main account?** Another consideration in setting up the arrangements is the designation/role of the Main Account Holder. Will the main account holder be acting as the principal for the group or as an agent on behalf of the participants?

■ **Is the region ripe for cross-border pooling?** Europe is the most common region for cross-border pooling primarily because of the single currency across multiple countries. Also the large global banks have the branch networks to handle both in-country transactions and the centralized back-office operations for seamless pooling, especially within the eurozone. Consequently physical pooling is most often used in this region.

There are also virtually no regulatory restrictions, although some countries, e.g., Belgium, require that the participating local subsidiary be a net contributor to the pool. (This also applies to a US entity participating in a EUR pool; they cannot be in a deficit cash position.)

■ **What about excess funds?** If the company has excess funds over and above what is required for subsidiary working capital needs, treasury must determine how to invest them and for what duration. Often pool investments are characterized as medium term for durations ranging from 90 days to six months, or potentially up to one year.

Pool-related investments can be made by the Holding Company and handled through the pool bank, another financial institution, or whatever investment approach is deemed suitable under the company's investment guidelines.

As these funds are still assets owned by the contributing subsidiaries, it makes sense that there be some type of clause/

IS POOLING ALLOWED?

	IN COUNTRY POOLING	CROSS BORDER POOLING
Non Convertible Currency	Maybe, varies by country	No
Offshore Accounts Permitted	Maybe, varies by country	Yes
Restrictions or withholding tax on intercompany lending	Problematic	Problematic
Debit tax on bank transactions	Notional only, if permitted	Yes, if account is offshore

Source: Treasury Alliance Group LLC

agreement in the intercompany loan documentation that allows treasury to invest these funds for the expected tenors. The tenor of a cash pooling arrangement is critical. For excess or deficit cash positions longer than one year—whether the company uses notional or physical pooling—it is advisable to create separate long term loan agreements with the participating subsidiaries in order to invest the funds on a group basis, or to finance the cash-poor subsidiaries using direct lending or cash infusion. This would most likely satisfy tax authorities.

Companies who have pooling arrangements—either physical or notional—have them in place as a temporary arrangement for the smoothing of excess/deficit positions among related companies. Loans and/or cross guarantees are put in place to protect participating subsidiaries and to mitigate risk.

Pooling is not a quick fix or a top-down solution for managing widely varying cash positions. Nor is it a way to earn interest on blocked cash in highly regulated countries or to escape withholding tax that may arise from intercompany lending. Pooling can certainly be an overlay—but the decision to set up the arrangement should come as a result of a review of banking needs and account structures—on a country, regional or global basis—and from an assessment of the overall corporate liquidity situation.

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ASK YOURSELF THIS...

Physical location of the entity that will hold the pool header accounts	■ This is a company decision based on tax benefits and logistical compatibility with other company locations. ■ The country where the entity is domiciled does not have to be the same country where the pool header accounts are located.
Country where the pool header accounts are domiciled	■ This decision is made on the basis of banking efficiency subject to regulatory compliance. ■ Pool header accounts are typically located where the selected banking partner maintains its back-office operations and/or where there is depth in the money markets. – In Europe, header accounts are most often domiciled in London or Amsterdam. – In Asia Pacific—Singapore is a common location for a USD pool header for those countries which can participate. – For US-domiciled operations (can be foreign owned) using a ZBA account structure in the US—interest cannot be paid on current accounts, thus a separate sweep will be required to earn interest—and that interest is subject to withholding tax. There are also reserve requirements on balances which means a portion of the balance cannot earn interest.
Physical location of each business' operational bank accounts	■ Operational bank accounts are usually located in the country where the business entity is incorporated and each business entity has its own bank account. ■ From a company perspective this is necessary to provide resident status for taxation and payment tariffs. ■ From a banking perspective, it is easier to collect and pay local currency funds from/to resident customers and vendors using local banking accounts at a branch (or strategic partner) of the pooling bank. There are no interest issues—the accounts are zero-balanced daily and the interest is earned by the entity holding the pool header accounts.
Interest earned or paid by the pool header accounts	■ This is the subject of negotiations between the company and the bank providing the header accounts. ■ The rates are typically based on a published benchmark such as EONIA with a negotiated spread on either side depending on whether the interest is earned or paid.
Interest earned or paid by the account holders	■ The interest rates can be determined by the company but must be on an arm's length basis. ■ The interest rates do not need to match the rates paid by the bank on the pool header accounts but should be related to market rates.
Interest allocation methodology	■ The interest allocation methodology is determined by the company. ■ The administration of this methodology is the responsibility of the company, but is facilitated by detailed information from the bank that can be downloaded for easy intercompany administration.

Source: *Treasury Alliance Group LLC*