FAS 123

A ‘Political Solution’ To ESO Expensing

In a hearing in Washington, the pro- and anti-expensing camps had a chance to outline their positions. The real issue, however, is who’s job it is to set rules on ESO accounting.

It’s deja vu all over again. When FAS 123 was debated, ultimately Congress forced a half-way house compromise on the FASB, which gave companies the option—but not the obligation—to expense employee stock options (ESOs).

And while the FASB has clearly made up its mind that options should now be expensed (see IT, 5/5/03), as treasurers have said all along (see IT, 1/27/03), the only remaining question is not what the FASB wants to do but what Congress is prepared to do to stop the accounting rule-making body from pursuing its plan. (The FASB says it is set to issue an exposure draft on expensing in Q4 of this year.)

In a hearing in Washington on June 3, pro- and anti-expensing camps took turns presenting their case. Their arguments were not new. The cast of characters was not surprising. What stood out, however, is that underlying the ESO-expensing debate in Washington is a basic disagreement about the role of the FASB and its so-called independence, when the Board’s actions have impact beyond “bean counting.”

A three-year delay

The hearing, before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises focused on a proposed bill (H.R. 1372). H.R. 1372 would basically stop the FASB’s “expensing train” in its tracks; it imposes a three-year moratorium on any new accounting rules that concern ESOs, and gives the SEC a mandate to require greater disclosure of ESO information, while studying the issue before any new action is taken.

The impetus for the introduction of H.R. 1372 is concern that the FASB’s plan to mandate option expensing will end the utility of options as

Global cash management

Crossborder Pooling: Notional vs. ZBA

By Susan Hillman Griffiths & William J. Zink

For many MNCs, the current emphasis on effective management of working capital has translated into renewed urgency in rationalizing liquidity structures. Part 1 of this two-part story reviews basic pooling arrangements. Part 2 will examine their related tax impacts.

The tight credit market—combined with general economic weakness—has forced a strong focus on cash and liquidity management (see IT 6/2/03) for both cash-rich and cash-poor companies.

As the ability to generate cash (or borrow it) has declined, MNCs report an increased need to have a clear view of their cash position globally. Visibility, however, is not enough. Treasurers also need effective techniques and procedures to manage their global liquidity. That task increases in complexity as a result of geographical spread, multiplicity of banking relationships, cross-currency flows and corporate structure issues (e.g., tax).

A consolidated view of cash

One of the most useful liquidity-management tools in the treasury toolbox is cash “pooling,” an arrangement whereby the credit/debit positions of different accounts are viewed from a single summary perspective.

This approach gives treasurers a chance to view cash on a regional and global basis, at the same time allowing affiliates to utilize their collective liquidity more effectively (i.e., instead of one subsidiary borrowing while the other is flush with cash).

Companies planning to centralize cash for multiple international subsidiaries have two basic options available:

• Zero balance accounts (ZBAs); or
• Notional cash pooling.

While both achieve the same ultimate objective, there are technical differences, which can

Anticipated Exposures

SEC NRSRO concept; Using Sarbanes-Oxley to sell treasury systems; and more.

Waiting for Thomas

To Fix FSCs

By Nilly Essaides

Alternative approaches to the fundamental problems plaguing the US tax code.
then have significant organizational and tax consequences to either approach.

Zero-balance accounts (ZBAs)

ZBAs refer to linked accounts at the same bank and in the same currency and country. Funds are physically transferred in/out (zero-balanced) from subaccounts to a main account daily.

This primary account is usually held in the name of the Corporate Parent, Country or Area Headquarters/Holding Company or a Regional Treasury Center, such as a BCC, IFSC or OHQ.

If the subaccount holders are divisions of the same legal entity (such as branches, sales offices or plants), there are no tax issues. Indeed, often companies use ZBAs as a simple method to segregate different types of activities, such as receipts and disbursements, even if there is no regional or organizational segregation already in place.

However, if the subaccount holders are separate legal entities (i.e., subsidiaries), the funds movement into the main account constitutes an intercompany loan from the subsidiary to the main account holder and vice versa; this, in turn, generates some tax and accounting issues.

Audit trail and accounting. For example, documentation must be maintained for audit trail purposes and the main account holder (e.g., central treasury) must charge an “arm’s length” interest rate to the participating subsidiaries. Although banks provide separate statements for each subaccount, they will not typically do the accounting, manage the loan portfolio or assess/pay interest. (Some banks do run separate businesses which provide these services on an outsourced basis, usually out of Dublin.)

So unless this aspect of recordkeeping etc. is handled by a bank or third-party outsourced service, it must be done internally. Many treasury workstations and ERPs provide intra-company loan-management functionality as part of their core offerings. If the activity is at all substantial, spreadsheet solutions may not be sufficient (and certainly won’t provide the layer of automation of both interest allocation/payment and reporting that makes this cost effective).

Cost benefits. In-country ZBA arrangements are very common and have been a staple of managing US cash for years. Yet they are not universally possible. In certain countries, such as Korea, ZBAs may not be permissible at all, and in countries where there is an assessment of debit tax on transactions out of a bank account, such as Australia, a ZBA arrangement may end up being not cost effective.

For treasurers managing subsidiaries in multiple countries/currencies, the ZBA structure can be set up as an overlay, but funds must first be physically transferred from country A, B or C to the concentration location.

Two-tier approach. Often there is a daily pooling/ZBA in the originating country first, and then a sweep or manual transfer to the location of the main account, with less frequency. Thus the cross-border ZBA is usually a two-tiered structure. Weekly transfers are fairly standard. Daily transfers cannot be cost justified except with the very largest multinationals. Therefore, in assessing the efficacy of overlay ZBA arrangements, a cost/benefit analysis is essential to establish the target level of cash required at the local level, and the frequency of transfer to the main account. Also overlay options may require opening additional in-country accounts, which can get expensive.

But perhaps the main drawback or limitation of ZBAs is that they’re only available on a single-currency basis. Thus, at the treasury level, there must be a main account for each separate currency.

Notional cash pooling

That’s where notional cash pooling enters the picture. With notional pooling, there is no physical movement of funds between accounts; rather, credit and debit interest are offset. Interest is paid/charged on the net balance position, but the legal/tax separation of separate subsidiaries owned by the same parent is maintained.

The initial (or direct) benefits of pooling come from the reduction of overdraft interest expense by centralizing the company’s liquidity position (see example in table on p. 7). Without a notional pool, each operation receives/pays interest separately, depending on their daily cash (bank balance) position. In a pooling arrangement, in the example, by grouping the entities’ total position, the group would earn 1.2 instead of paying 3, which would result from Sub C’s overdraft situation. Bank statements are received separately by
The individual vs. 'pooled' view: Comparing results

<table>
<thead>
<tr>
<th>Entity</th>
<th>Balance Position</th>
<th>Interest Earned/Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub A</td>
<td>+100</td>
<td>3% earn 3, without pooling</td>
</tr>
<tr>
<td>Sub B</td>
<td>+40</td>
<td>3% earn 1.2, without pooling</td>
</tr>
<tr>
<td>Sub C</td>
<td>(50)</td>
<td>6% pay 3, without pooling</td>
</tr>
</tbody>
</table>

Pool result: +90 earn 1.2

Notional: Key Aspects

The following are the key characteristics of a notional pooling arrangement:
- Same bank/ different branches
- Same country is most common
- Multicurrency pooling is extremely sensitive from a tax and accounting perspective—Spain can’t participate, for example due to local tax regulations
- Cross guarantees are required by the bank, regardless of the cash position of the participants
- Interest actually charged/paid to participants is optional—but may be advisable from a tax perspective.
FAS 123
The Coming ESO
Valuation Debate

Seemingly undaunted by the lobby-induced Congressional effort to impose a three-year moratorium on option expensing (see IT, 6/16/03), the FASB presented its progress and plans on the stock compensation project, during last week’s quarterly meeting with the Financial Accounting Standards Advisory Council (FASAC).

When asked by one of FASAC’s members if recent Congressional discussions had introduced any new information to the Board’s deliberations on stock compensation, FASB Chairman Bob Herz responded that “listening to people is always good,” but the technical arguments Congress is making have all been heard before (e.g., not an expense, but a transfer of interests between shareholders).

He did say that he finds the macro-level economic arguments, about how expensing options would be detrimental to Silicon Valley and its competitive advantage vis-à-vis Asia, “interesting as a citizen, but not as an accountant.”

Hence, the good accounting/bad economics card remains the best one for the anti-expensing crowd. Outside the tech industry, the FASAC discussion indicated, companies are resigned to (if not approving of) expensing options, which leaves the matter of the correct way of measuring/expensing them (see IT, 5/5/03).

‘Ringers’ for the FASB team

By most accounts, “correct expensing” means appropriate valuation methodology(ies), since the timing of recognition appears to be established—e.g., the modified grant date. Option valuation is thus the next item on the FASB’s fast-paced ESO agenda.

Put July 8 on your calendar now. That’s the date for the first meeting of the Board with the

Crossborder pooling
Part 2: Structural & Tax Considerations

By Susan Hillman Griffiths & William J. Zink

The second of a two-part series on crossborder pooling, this article focuses on the key tax ramifications of notional pools vs. ZBAs

For many MNCs, the impetus for pooling may be effective management of global liquidity (see IT, 6/16/03), but the decision of whether to choose notional pooling or use ZBAs is grounded in tax implications.

And while obtaining a favorable tax treatment is of utmost importance, it is not necessarily the liquidity technique which determines the tax outcome (assuming both are allowed). Rather, it’s the content of the underlying agency agreement between the main account holder and the pool participants.

Who’s the main ‘holder’?

One important consideration is whether the main account holder (be it the corporate treasury, a treasury center, BV etc.) acts as the principal for the group, or else as an agent on behalf of the various participants.

Typically, if the main holder acts as “principal,” it will deem the interest as intercompany. If the main account holder is acting as an agent for the subsidiaries, the interest will be considered bank interest.

Just how interest is defined (interco or not) then becomes a key determination of tax treatment. For example, the type of interest will affect the allocation back to the participants, and the taxation levied on them in their own tax jurisdiction.

Withholding tax applicable in each respective country may be applied to the interest earned by each participant, even in a notional pooling arrangement.

In addition to withholding tax, the interest earned in the centralized arrangement can raise other tax and accounting concerns. For exam-
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Cross-border Pooling, continued from page 1

‘De-complexing’

If a company has multiple operations in each country, individual, country-level pools should be set up first, before any regional or global arrangements. For mid-size MNCs, it may not be then necessary to impose the regional overlay; this results in fewer tax “headaches” as cross-jurisdictional issues do not arise.

...ple, there may be a mismatch between the tax treatment allowed under interest recognized on a cash vs accrual basis.

Also, pooling might affect a company’s foreign tax credits (FTCs). Here, the question would be where (in which basket) to include the interest income, since the latter is considered “passive” income under subpart F rules, which means US taxes on it cannot be deferred (see IT, 6/16/03).

Also, if treasury in the US is the holder of the main account, the arrangement would most likely raise further subpart F issues (i.e., deemed dividends). As a result of these rules, the US treasury should not be a direct participant in any bank pooling arrangement.

Non-US tax agencies are not passive on this issue either. If the main account holder or Manager is an existing Dutch BV, treasury/tax would have to examine existing arrangements with local tax authorities. Very often, BV incorporation regulations contain specific rules that no management fees can be charged. However, by acting as an agent, the BV has treasury functionality, which may in turn raise thin-capitalization issue with local regulators.

Three rules of thumb

Basically, any liquidity management structure — either physical (ZBA) or notional pooling — must comply with three basic requirements:

1. **Arm’s-length interest allocation.** The arrangements, including deposits, credit lines, etc., among the participants should reflect an arm’s-length market price.

   Although the manager or agent may have discretion in allocating the interest income and expense among participants, this interest should be based on supportable arm’s-length pricing.

2. **Business purpose.** The entire structure must have a bona fide business purpose other than tax avoidance or circumvention of non-tax legal constraints.

   In cases when the net lending and net borrowing positions of the various participants are brief in duration or de minimis in amount, and the pool is used by the corporate treasury primarily as a liquidity management tool, the risk of recharacterization would be small.

3. **Economic substance.** The participants are responsible legally, which includes duty to pay, rate risk, risk of default, etc. Cross-guarantees, cross-indemnities and other rights of offset are used as protective measures for the banks and should not be a concern as long as all participants are legitimate and solvent. Intercompany compensation at arm’s-length rates with respect to guarantees provides additional support.

Cross-jurisdictional issues

Even if these basic requirements are in place, one of the main difficulties in any cross-border pooling or ZBA scheme is the cross-jurisdictional nature of the arrangement.

The participants are subsidiaries in different countries, each subject to the tax and regulatory requirements in that location. Even in Europe (despite the EU, the euro and the supposed benefits of a single market), tax harmonization does not exist yet.

And yet it is often within Europe that companies are most interested in pooling, since the euro enables more efficient ZBA structures; plus, some of the barriers to notional pooling have been removed with the aid of technological advancement (see IT, 5/6/02).

Some of the cross-jurisdictional considerations for treasuries include:

1. **Who earns the interest?** If the company is viewed as lending and borrowing among corporate members, certain jurisdictions will insist that interest is earned by a lending corporate member.

   This is especially true if the fiscal authorities of the particular jurisdiction follow the arm’s-length principle. In more lenient jurisdictions, the decision to charge interest on related party lending will be at the discretion of corporate treasury.

2. **Withholding taxes.** Local tax authorities may also insist that if interest is actually or notionally present, a withholding tax on such interest could apply.

   Consider, for example, a Canadian subsidiary of a US MNC, which participates in a London-based pool: Interest earned by the Canadian sub in the UK could be subject to UK withholding tax.

3. **Related vs. not.** Cash pooling could also be viewed as a transaction between the bank and the borrowing member, rather than as a related party loan. In such jurisdictions, the interest rate is at the discretion of corporate...
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treasury, irrespective of whether or not the arm’s-length principle applies.

(4) Dividends. If a US corporate participant is viewed as drawing directly against its foreign affiliate, this transaction could be viewed as a taxable dividend to the US corporate participant. And even if the US corporate parent is viewed as drawing on the bank, with the guarantee of a foreign affiliate, it may face the same taxable dividend exposure.

(5) CFC impact. Another complication arises from the interest income of pooling arrangements, particularly where the corporate parent of a foreign corporate participant is in a country that has adopted controlled foreign corporation (CFC) legislation, e.g., US, UK, Germany, Japan, etc.

In these jurisdictions, the interest income earned by the foreign corporate participant could be treated as a taxable dividend to its corporate parent, despite the fact that no cash has been transferred.

(6) Cross-guarantees. The confusing cross-guarantee aspect of the transaction may trigger US income-tax consequences to a US corporate participant, depending upon whether the US corporate participant is in a surplus or deficit position:

- Surplus position—when non-US affiliates are in a deficit position, and draw against the surplus position of the US parent. If cross-guarantees exist, the US tax authorities may insist the US entity has performed a service for its affiliates, i.e., guaranteed their repayment of the draws to the bank. Accordingly, a service fee would be deemed earned by the US corporation.
- Deficit position—drawing against its affiliate’s surplus position, where cross-guarantees exist, the guarantee will be viewed as a taxable dividend from the foreign surplus affiliate to the US corporate participant.

Although the US tax effect of this dividend can be reduced by available foreign tax credits, the deemed dividend impact normally discourages US participation.

(7) Co-mingling. Whenever funds are commingled, and a US corporation participates in the arrangement, the US corporate member will be viewed as having constructive receipts and thus create a tax liability in advance of what would otherwise be expected.

Thus, a US-incorporated subsidiary (a Delaware company, for example) cannot participate in a pooling arrangement, even if it is in London. However, this often erases the whole benefit of the arrangement as (usually) the US parent has the largest cash flows and requirements.

So, before crossborder pooling arrangements are set up, the company should consider some type of offshore company to manage the pool depending on whether such an approach is compatible with the company’s overall tax strategy.

(8) Accounting complications. Finally, companies must also consider FASB Interpretation No. 39 (Offsetting of Amounts Related to Certain Contracts; see IT, 5/30/94)

This FASB guidance tells banks which contracts on their books can be condensed into a single line item, and whether the right of offset can be upheld in the event of bankruptcy.

It may be very difficult for a bank to justify the offset (the basis of a pooling arrangement) in those jurisdictions (countries) where the provisions for offset are not clearly stated. Because the UK has clear rules regarding offset, many banks have opted to set up their pooling services in London.

Conclusion

For efficient and more centralized international treasury management, crossborder pooling, including ZBAs and notional cash pooling, can be excellent tools.

However, these arrangements can’t be considered a panacea or a quick fix solution. There are numerous tax issues as well as difficulties in implementation. Often, it involves stripping some cash management responsibilities from affiliates and their finance staff.

Plus, such arrangements are only offered by a small number of banking institutions.

Pooling arrangements often sound elegant and effective in theory, but treasurers are cautioned not to be swayed by presentations by enormous multinationals and large banks, which praise the efficiency of their pooling system. Instead, treasury should review the operational and tax parameters of different pooling approaches, based on the company’s business and legal first, to determine if it offers a solution to global liquidity challenges.

Susan Hillman Griffiths is a principal with Treasury Alliance LLC, +847-295-6414; William Zink is a tax partner with Grant Thornton International, +312-602-9036.

**Taxing** tax items

Here’s a checklist of some of the key items to consider when evaluating the corporate tax impact of crossborder pooling:

- Principal or agent as main account holder.
- Impact on the company’s foreign tax credit (FTC) position.
- Subpart F income issues—i.e., does the arrangement generate passive income?
- Jurisdictional considerations in terms of paying and/or charging interest.
- Cross-guarantees in a notional pool.
- Intercompany loans for ZBAs.