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Physical cash pooling in a negative interest rate environment

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Introduction

The financial crisis had made multinational enterprises (MNE) look inward for funding options, as external sources of capital were not readily available. Among various intra group-financing possibilities, cash pooling among group members is undoubtedly one of the most important tools to facilitate cash management. Even though tax authorities recognize the commercial rationale of such arrangements they nevertheless carry out detailed tax audits to determine the transfer pricing (TP) aspects of cash pools. Considering that the OECD has not yet released its guidance on financial transactions, the purpose of this blog is to discuss key issues regarding the TP aspects of physical cash pooling agreements.

The concept of cash pooling

Cash pooling can generally be done on a notional or on a physical basis. Notional cash pooling comprises a virtual concentration of the cash of the pooling members on a virtual account, whereas, under a physical cash pooling arrangement, the cash and debt positions of the cash pooling members are physically balanced by the master account of the cash-pooling leader (typically, the financing entity of the group). Further, while notional cash pooling can economically be regarded as a simple interest rate compensation arrangement, physical cash pooling establishes intra-group loans between the cash pool leader and the cash pool members and vice versa. A general effect of cash pooling is that the group only pays or receives interest on the net (consolidated) cash amount. Such pooling arrangements not only reduce the external funding costs but they can also generate bargaining power possibilities resulting in better terms with the banks, in particular, a reduction of banking fees.

The cash pool leader may generally conduct its activities on a wide spectrum. At one end of the spectrum, the external bank may perform all functions related to the cash pool. In this situation, the role of the cash pool leader can be limited to that of a financial service provider. For instance, the cash pool leader could only be responsible for the assurance of the daily cash transfers, the calculation of the interest expenses and the issuance of reports on the cash positions of the cash pooling members.

However, at the other end of the spectrum, the cash pool leader may also assume an entrepreneurial role and perform key functions, employing more assets and assuming higher risks. The cash pool leader could indeed be in the position to decide on major issues, specifically, liquidity planning in the group and could have completely internalized the cash accounts of the cash pooling members. It may negotiate with the banks and, correspondingly, take all relevant decisions with regard to external (short-term) funding, portfolio strategies (e.g. hedging, investment of surplus cash) and the internal allocation of (short-term) cash on the basis of the specific needs of the group companies. Such a cash pool leader can arguably be characterized as an internal bank.

Remuneration of the cash pool leader

The cash pool leader should be remunerated on the basis the value it creates. In other words, its remuneration will depend on the functions actually performed, assets actually used and risks actually assumed. The OECD has developed a risk and return framework i.e. a six-step approach for delineating the transaction. In a nutshell, the framework suggests that income should be allocated to an entity that “*controls*” and has the “*financial capacity*” to bear the relevant significant risk. That framework could also be applied to determine the arm’s length remuneration of the cash pool leader.

As already discussed, physical cash pooling establishes intra-group loans between the cash pool leader and the other parties of the cash pool. These intra-group loans need to be priced at arm’s length. The identification and attribution of the (internal) credit default risks of the cash pool borrowers seems to play a key role for the determination of the arm’s length remuneration of the cash pool leader. In the post BEPS environment, a cash pool leader without significant functions and capital at risk would not be in a position to bear the credit default risk of the cash pool borrowers. In such circumstances, the (internal) credit default risk can likely be attributed to the cash pool depositors since they would economically be affected from a default of a cash pool borrower. The cash pool depositors could therefore be regarded as the parties that are entitled to earn an interest income on the basis of the (individual) credit default risk of the cash pool borrowers (adjusted for implicit support). A cash pool leader which does not employ significant functions, assets and risks should, correspondingly, not be entitled to earn more than a routine return. A cost plus approach seems to be a reasonable option in cases where the role of the cash pool leader is limited to that of a simple service provider.

However, the cash pool leader could also assume an entrepreneurial role along the finance function of the group by employing more functions, assets and risks. If the cash pool leader has a sufficient amount of equity at risk, employs the people to take the relevant decisions with regard to that risk and conducts the relevant risk management activities, logically, the credit risk should be allocated to it. Put differently, a cash pool leader with such characteristics would actually take over the internal default risks of the cash pool borrowers. The cash pool depositors would economically not bear the same level of risk compared to the situation where the cash pool leader only employs limited functions and has a limited amount of equity at risk. The amount of interest income of the cash pool depositors should correspondingly be lower. In such a scenario, the arm’s length remuneration of the cash pool leader could

indeed be an interest spread between a lower interest rate on cash pool deposits and a higher interest rate on cash pool borrowings. In this situation, the question arises as to whether the cash pool depositors should continue in the cash pool. The option realistically available to the cash pooling depositors with regard to short-term cash could, for instance, consist of a cash deposit with the local bank. In our opinion, as long as the interest rate on cash pool deposits is at least as favorable than the interest rate of the local bank, an independent party would not necessarily decide to leave the cash pool.

Allocation of additional benefits from group synergies

The establishment of a cash pool could create additional benefits, which would not be available to a single cash pooling party without cash pooling. These additional benefits could consist of better terms of the cash pool leader with its bank. For instance, the bank of the cash pool leader may decide to apply a more favorable interest rate on the surplus cash of the cash pool leader due to the cash concentration within the cash pool and the resulting enhanced bargaining position of the cash pool leader. This additional benefit is generally not absorbed through a stand-alone pricing of the short-term intra-group loans in the cash pool. A comparison between the interest rates on the master account and the interest rates in a fictional situation without the cash pool can be the basis to quantify and derive the additional positive interest effect from the establishment of the cash pool. That said, if these additional benefits can be quantified and separated, potentially some sort of indirect allocation mechanism can indeed be an option to share the benefit within the cash pool.

But, who should be entitled to receive this additional benefit? Generally, the allocation mechanism should reflect the individual contributions of the parties in the value creation process. Nevertheless, the reasons for the more favorable terms applied by the bank on the master account of the cash pool leader may be multifold (e.g. credit ratings of the group and the single group companies, cash volume, number of cash pooling participants, capital employed etc). Thus, the mechanism to distribute additional benefits derived should reflect these determinants. Consequently, in addition to the depositors, the cash pooling borrowers and the cash pool leader may potentially be entitled to receive a portion of the residual cash pool benefit achieved through economies of scale.

Implications of the negative interest rates environment

In recent years, some central banks including the European Central Bank have established negative interest rate policies. More and more MNEs have to cope with negative interest rates as the banks may even block cash transfer to the account over a target limit. Cash concentration on a single account may therefore be adversely affected. The negative interest rate may even be higher due to cash concentration comparing to a situation where each group company individually deposits its cash with its local bank. Cash concentration in a negative interest rate environment may therefore create negative synergy effects.

Given the current environment, it may be foreseeable that under such circumstance over the long run the benefits associated may no longer be commercially viable from

the perspective of the single cash-pooling member. However, it is imaginable that if independent parties had established a cash pool they would not immediately change their behavior for potential short-term market fluctuations and would also consider what the future expectations would be. In reality, what a cash pool is more beneficial for is pure cash management ensuring that all the money in the group is visible and utilized to optimize third party funding. Therefore, also in the negative interest rate environment, at least from the group's perspective, cash pooling has arguably always a commercial rationale.

The question is, if it is identified that there is a potential residual cash pool disadvantage resulting from negative group synergies how should this then be shared between the parties? The residual cash pool disadvantage should be potentially shared based on the same principles as a cash pool advantage. The mechanism used should reflect the contribution of the parties to the creation of the disadvantage. However, please note that the cash pool depositors alone should not be regarded as the only creators of the negative synergy effect. This is also a matter of consistency. In cases where the cash pool leader assumes an entrepreneurial role along the finance function of the group, he may also bear a portion of the disadvantage since he may economically bear certain financial as well as market risks.

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