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HMRC Guidance on Cash Pooling – Transfer Pricing Considerations

On 6 February 2017, HM Revenue & Customs ("HMRC") published their guidance on the tax considerations of cash pooling arrangements. The guidance is included in the International Manual at INTM503100, and has a focus on transfer pricing matters, including: the setting of interest rates; commentary on synergies achieved through cash pooling and how the benefit of a cash pooling arrangement should be apportioned among the cash pool header and the pool participants; the implication of long term versus short term balances; and the consequences of netting balances and the circumstances in which this might be appropriate.

Overall, the guidance illustrates that HMRC, in common with other tax authorities, have an increased focus on cash pooling.

Summary

There are many commercial benefits of cash pooling arrangements within groups of companies, which may include a reduction in external borrowing costs, liquidity management, better foreign exchange management, and greater visibility of cash flows.

These arrangements can result in potentially complex transfer pricing issues when determining the allocation of the benefit of such arrangements amongst members of a group. HMRC, however, acknowledge that the principal reason for groups entering into such arrangements is for commercial rather than tax reasons.

Cash pooling arrangements can vary widely, from fairly simple to highly complex. The guidance does not require the implementation of a series of strict allocation methods, recognising, instead, the need to assess each case on its individual merits – including the legal arrangements in place and the functions, assets and risks of the pool header and each participant.

Deloitte comments

Historically, HMRC's general transfer pricing guidance has been applied to cash pooling arrangements, so we welcome this new guidance addressing the specific challenges of pricing cash pooling arrangements and, in particular, the recognition that no two cash pools work in the same way and that there is a need to use a pragmatic approach and consider the facts and circumstances of each individual case. The guidance has been designed to provide an overview of cash pooling arrangements, and the factors which should be considered in determining transfer prices.

The guidance appears to be in response to Actions 8 – 10 of the OECD's Base Erosion and Profit Shifting ("BEPS") reports, which state that *'synergistic benefits and burdens of group membership may arise because of deliberate concerted actions and may give an MNE group a material, clearly identifiable structural advantage'.* The report goes on to state *'if important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy'*. There have also been a number of recent European cases that have considered similar issues specifically in relation to cash pooling, the conclusions of which are broadly aligned with the Actions 8 – 10 recommendations.

An area of particular focus for HMRC is the distinction between short and long term balances and the separate transfer pricing and tax consequences of each. HMRC's focus will of course be on risk to the UK tax base and the nature of cash pooling arrangements is such that different tax authorities could take different views on the appropriate allocation of the benefits, presenting the risk of double taxation absent careful analysis and regular monitoring of the arrangement, and subject to compensating adjustments through mutual agreement.

Although it is clear that every attempt has been made to produce a guide which will be helpful to both taxpayers and advisors, as well as HMRC, this guidance does not address all aspects of cash pooling. The basic examples included within the guidance could overly simplify the complex issues if the guidance is applied too rigidly. Our experience suggests that HMRC are generally taking a balanced and pragmatic view in considering the individual merits of each case; however, as this becomes more of an area of focus for HMRC, groups should ensure that they have clearly documented and implemented policies with regards to transfer pricing for their cash pooling arrangements.

The guidance represents a further example of the increasing focus given by tax authorities to a group's financing and treasury operations and in particular, whether the returns to a company adequately reflect the company's capacity and expertise to assess and manage risk. In the UK, historically we have seen HMRC focus on UK companies' level of indebtedness from a transfer pricing perspective, but the advent of the new corporate interest restriction, the commentary in the BEPS Actions 8-10 report on cash-boxes, European case law on cash management and the expected OECD guidance on the pricing of financial transactions later this year will likely result in increased enquiries in this area.

What the guidance says

Cash pooling is a term used to describe a variety of methods of managing a group's cash position on a consolidated basis, effectively concentrating the group's cash in one, or a smaller number of places. There are two main types of cash pooling:

- Notional Cash Pooling: Cash balances are netted off without cash actually moving;

- Zero balancing or Physical Cash Pooling: Cash is physically swept into a header account.

The guidance confirms that the benefit of the cash pool must be allocated in accordance with the arm's length principle i.e. that which would have been made as between independent enterprises. This is challenging as cash pooling arrangements generally only exist in a related party context.

A number of areas are highlighted in the guidance when considering the transfer pricing aspects of cash pooling, including:

- The rate of return achieved by a depositor into the cash pool, how this varies depending on the risk of the borrower and how it compares to the rate of return which would have been available from other 'options realistically available' to the depositor, e.g. depositing cash with a third party bank;

- The rate of interest being paid by a borrower, and how this compares to the rate that the borrower would pay if it were to obtain funding directly from a third party;

- What level of risk is being borne by the cash pool header and what return they should make for their activities; and

- The need to consider whether balances are short or long term and how each should be priced. This is potentially a very difficult area given balances can fluctuate daily.

The guidance does not serve to answer each of these questions but provides a number of potential approaches which should be considered in the context of each specific group. For example, when setting appropriate interest rates, the guidance gives four possible methods of allocating the benefit of the cash pooling arrangement between group entities:

1. All the benefit flows to the borrowers;
2. All the benefit flows to the depositors;
3. All the benefit flows to the cash pool header; or
4. The benefit is allocated such that all the participants to the arrangement are made better off than their alternative standalone positions.

HMRC state that, typically, groups will set interest rates which result in each participant being slightly better off than they would have been without the arrangement, but they also acknowledge that this is not always the case. HMRC note that implicit support, or 'passive assertion', may be a relevant consideration, although we note that this is arguably inconsistent with the UK domestic legislation on informal intra-group guarantees. The possibility of using a profit-split methodology is also noted, which was a method followed in the Norwegian case of *ConocoPhillips* but can be difficult to apply in practice.

The guidance then considers three specific scenarios, and provides comments on each. These include where the UK entity is:

- A long term depositor;
- A long term borrower; or
- The cash pool header.

In relation to cash pool headers, HMRC note that the various deposits and deficits will not necessarily be viewed as a series of transaction to be taken together – illustrating the possible risks of one-sided adjustments e.g. to increase returns on core deposits only.

The guidance also highlights that it is possible for a UK entity to be both a borrower and a depositor. Recent Danish case law that considered this point decided that balances should be 'netted off' and interest should be calculated on a net basis. The HMRC guidance highlights that, whilst it is accepted that balances with the same participant could be netted off, netting at a country level would be subject to local laws and may not necessarily

be permitted; however, practically, due to the existence of a parent – subsidiary relationship, there may be arguments for assessing their respective deposit/ borrowing position on a net basis.

With HMRC increasingly focused on cash pooling and intra-group financing arrangements, any group with cash pooling arrangements in place, or those considering implementing such an arrangement should ensure that appropriate policies are developed, documented, and adhered to – this latter point being particularly important, as we often see cases of cash pooling balances becoming 'core', leading to the potential pricing and withholding tax challenges referred to in HMRC's guidance.

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