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Cash pooling during and in the aftermath of the Covid-19 pandemic

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As businesses across the world struggle to deal with the economic impact of the Covid-19 pandemic, liquidity and freeing up much needed cash resources has become the main concern for many businesses. MNEs have had to amend their existing financing arrangements and deploy alternative strategies to preserve liquidity. Centralized MNE management is more involved with managing cash pools as cash pool participants making withdrawals at the same time can (quickly) exhaust the credit limit of the cash pool. Along with this the probability to incur losses derived from the default of cash pool members with debit positions (to bear the credit risk) has increased. Cash pool participants might have to rely on additional short-term group financing and cross guarantees (in relation to third party lending) for emergency liquidity. This may affect the taxation of the existing cash pooling arrangements, in terms of benefit and risk allocation. In this regard, MNEs with cash pool arrangements during the Covid-19 pandemic should take note of the following considerations:

- Remuneration of the cash pool leader (as centralized management involvement increases)
- Long-term debt and credit positions (probability of default increases)
- Alternative benefit allocation (focus on long term deposits)
- Are guarantees during the Covid-19 pandemic still implicit support?
- Increased necessity for cash pooling arrangements (to facilitate the cross-border liquidity management)
- Short-term liquidity needs may drive transfer pricing

Remuneration of the cash pool leader may change due to the Covid-19 pandemic

In most cash pool arrangements, the cash pool leader performs no more than a co-ordination or agency function with the master account being a centralised point for a series of book entries to meet the pre-determined target balances for the pool members. Given such a low level of functionality, the cash pool leader's remuneration as a service provider will generally be limited. This position is also reflected in Chapter X of the OECD's Transfer Pricing Guidelines on Financial Transactions released on 11 February 2020 ("OECD TP-FT"). The OECD TP-FT states that the remuneration of the cash pool leader and participants should reflect their respective exposure to the economically significant risks (including, liquidity risk and credit risk) associated with the cash pooling arrangement.

During, and in the aftermath of the pandemic, both, liquidity risk and credit risk, of cash pool members in most cases has increased. The immediate impact of lock-downs across a number of jurisdictions has triggered an urgent need for liquidity and cash support along with the management of cash/liquidity support/relief measures that have spread unevenly through various entities in cash pool arrangements. As a result of the Covid-19 pandemic many MNE's have centralized (at least to a certain extent) treasury/liquidity management and key group management is actively involved in managing the cash/liquidity management. These consequences may pose difficulties for both MNEs and revenue authorities in analysing cash pooling arrangements. It may be difficult to access sufficient information to verify the position that cash pool leaders perform no more than a co-ordination or agency function. In addition, as most tax bases will erode as a result of the Covid-19 pandemic, revenue authorities may scrutinize/challenge the remuneration of the cash pool leader and the participants to a cash pool.

It is important to identify and examine the economically significant risks associated to cash pooling arrangements during the Covid-19 pandemic. These risks should be analysed taking into account the (expected) short-term nature of the credit and debit positions as a result of the Covid-19 pandemic. Based on experiences obtained with CFOs the liquidity risk during the pandemic involves a level of control/management beyond the mere offsetting of the credit and debit positions of cash pool members. The same applies with the management of the credit risk. Centralized management is more involved with managing the probability to incur losses derived from the default of cash pool members with debit positions (to bear the credit risk).

Therefore an examination will be required to understand which entity is exercising control functions and has the financial capacity to assume the liquidity and credit risk associated. Such an analysis may show that during the pandemic the cash pool leader is performing functions and assuming risks that go beyond the coordination role of a cash pool leader. In that case, the functional analysis may show that the cash pool leader controls the financial risks (mainly liquidity and credit) and has the financial capacity to bear those risks. Accordingly, the cash pool leader should be compensated for the functions it performs and the risks it assumed. This may include earning large part of the spread between the borrowing and lending positions.

Debt and credit positions may become more long term

Another observation during the Covid-19 pandemic is that cash pools, rather than functioning as part of a short-term liquidity-driven arrangement that manages debit and credit cash positions, have become more long term. Many cash pool participants have made withdrawals at the same time in order to cover their cash demands as credit limits can quickly be reached during the Covid-19 pandemic. In first instance it is important, based on the OECD TP-FT of Section B, to characterize long-term debit and credit positions. This is not only important to determine whether the allocated/determined cash pool remuneration provided is at arm's length. It is also important to understand whether prima facie a long-term debit/credit position in a cash pool can be regarded as something other than a short-term cash pool balance, such as a longer term deposit, a long term loan or some other kind of payment, in particular a contribution to equity capital or deemed dividend.

One of the practical difficulties in such situations will be deciding how long a balance should be treated as part of the cash pool and/or at what moment a contribution to equity could be considered. By nature a cash pool is likely to differ from a deposit or a long-term loan. Both a deposit and a loan are typically transactions that can be viewed in isolation (for instance a deposit with a bank is done with a view to a obtain a depositor return). This isolated approach is typically not possible in any cash pool arrangement. Cash pool arrangements in this respect contain a certain element of implicit support of other group members. It could be argued that long(er) debit and credit positions represent nothing more than an acknowledgement that it would be for the benefit of the group to support the performance of the cash pool participants. If the debit and credit positions *(i)* increase (in terms of timing and amount) and *(ii)* if, in particular, the credit and liquidity risk management of the cash pool leader increases, discussions/challenges with revenue authorities are expected.

Alternative benefit allocation (focus on long term deposits)

In general the remuneration of cash pool participants will be calculated through the sharing of interest rates benefits (netting of shared benefits). This is generally done once the remuneration of the cash pool leader has been determined (that typically performs a routine/agency function). This approach however assumes a straightforward cash pool arrangement before the Covid-19 pandemic. As a result of the Covid-19 pandemic the functions (as described before) of the cash pool leader may have altered (incl. the management of key risks such as credit and liquidity) and the outstanding positions between cash pool participants may have increased (in terms of volume) and extended (in terms of outstanding periods).

Conceptually it is (always) expected that (all) cash pool participants will be better off than in the absence of a cash pool arrangement. In principle, all cash pool participants would benefit from enhanced interest rates applicable to debit and credit position within the cash pooling arrangement compared to the rates that they would expect to obtain from borrowing or depositing cash outside of the pool. It would be important to note that cash pool participants might also be willing to participate to obtain a permanent source of financing, reduced exposure to external banks and/or access emergency liquidity support.

The mere netting of benefits among the pool participants, may change as a result of the Covid-19 pandemic, as the pooling benefits or even the disadvantages of participating in a cash pool have altered. Especially during the Covid-19 pandemic the availability of a permanent source of financing and access to emergency liquidity support may be critical. Along with this the probability to incur losses derived from the default of cash pool members with debit positions has increased. During and in the aftermath of the Covid-19 pandemic, revenue authorities may take the position that the actual benefit, in case of long-term outstanding debit positions and increased credit risk to the depositors, may be allocated among the net depositors to the pool. It could be argued that these companies have their capital at risk (across all net borrowers) and accordingly should be entitled to any benefit arising from the use of that capital.

This view was also suggested by the 2018 OECD TP-FT draft discussion document. However the OECD TP-FT has not prescribed or recommended specifically any approach in this regard claiming that it does not intend to provide a prescriptive approach for allocating the cash pooling benefits to the participating cash pool members in any given situation. From a practical standpoint, for instance, in the *ConocoPhilips* case (as discussed in the court cases blog) the Norwegian revenue authorities and the Court held that remunerations to cash pool members need to be determined based on the bargaining power and credit risk of each individual cash pool participant. This underpins the argument that the net depositors should be rewarded proportional to their capital used in the pool and associated risks.

Are guarantees during the Covid-19 pandemic still implicit support?

One of the key difficulties in understanding the transfer pricing impact of any cash pool arrangement is the fact that any cash pool cannot be viewed in isolation, in particular during the Covid-19 pandemic: *(i)* A cash pool leader likely has enhanced its' management of key risk elements (credit and liquidity risk), (*ii)* the net depositors may desire a larger part of the group benefit and *(iii)* group members that are in (temporarily) distress may want to enter into a cash pool because of the access to emergency liquidity. These elements may impact how cross-guarantees, that are typically seen within cash pools are characterized.

In typical cash pool arrangement (as seen before the Covid-19 pandemic) it is assumed that there are entities with debit positions and entities with credit positions, that each pool participant has a different credit rating, and that the pooling agreement with the bank requires (full) cross-guarantees between the pool participants. Para 10.148 of the OECD TP-FT is relatively clear on these types of cross-guarantees and assumes that each guarantor has no *"control over membership of the pool, has no control over the quantum of the debt which it is guaranteeing, and may not be able to access information on the parties for whom it is providing a guarantee." Hence, it could be argued that the cross guarantee "may represent nothing more than an acknowledgement that it would be detrimental to the interests of the MNE group not to support the performance of the cash pool leader and so, by extension, the borrower."*

In these cases, and again assuming a pré-Covid-19 pandemic cash pool arrangement, any company that borrows in a cash pool may not perceive a benefit in excess of the implicit support of other group members. This conclusion may be altered observing the impact that the Covid-19 pandemic may have on the actual decision-making process in relation to credit and liquidity risk and the (likely enhanced) involvement of group management. Revenue authorities could for instance argue (based on the facts and circumstances) that in case of excess/long-term debit positions a cross-guarantee exceeds the level of implicit support. The *Portuguese revenue authorities vs S.A. Cash Corp case* (as discussed in the court cases blog) is a good example for this. It could also be reasoned that in certain cases no guarantee fee could be due, but, however that any support in case of a default from a group member, should be regarded as a capital contribution or a deemed dividend.

Concluding remarks

During and in the aftermath of the Covid-19 pandemic centralized management is more involved with managing cash pools as cash pool participants making withdrawals at the same time can (quickly) exhaust the credit limit of the cash pool. Especially during the Covid-19 pandemic the availability of a permanent source of financing and access to emergency liquidity support may be critical. Along with this the probability to incur losses derived from the default of cash pool members with debit positions (to bear the credit risk) has increased.

This may affect the taxation of the existing cash pooling arrangements, in terms of benefit and risk allocation, which typically is already complicated as any cash pool arrangement cannot be viewed in isolation. In particular during the Covid-19 pandemic *(i)* a cash pool leader likely has enhanced its' management of key risk elements (credit and liquidity risk), *(ii)* the net depositors may desire a larger part of the group benefit and *(iii)* group members that are in (temporarily) distress may want to enter into a cash pool because of the access to emergency liquidity. These elements may *(iv)* also impact how cross-guarantees, that are typically seen within cash pools are characterized.

We expect that in the next years revenue authorities will discuss and challenge the transfer pricing features of cash pooling arrangement from the perspective of the cash pool leader and the participants. We have analyzed existing court cases (Bombardier, ConocoPhilips et al) in relation to cash pooling arrangement. Based on the existing court cases along with the OECD TP-FT companies may consider strengthening the transfer pricing documentation involving cash pool arrangements during and in the aftermath of the Covid-19 pandemic. For a more detailed analysis of the exiting court cases, you can find our blog on this topic here.

Author(s):
By **Neha Mohan** , Birhanu T. Daba and Patrick T.F. Schrievers