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Cash pool: from A to Z (2) (1/29/19)

This article picks up where we left off on the subject of cash pools and explores whether taking part in a cash pool creates a taxable item.

Before 2018, any transfer of funds to a cash pool was exempt from corporate income tax (CIT). In 2018, the tax reform came into force with new rules and principles for CIT treatment.

The general principle in the CIT Act

Related-party lending is taxable under the CIT Act. However, there are still many grey areas and interpretations surrounding the CIT treatment of cash pools, including the question of whether placing funds in a cash pool is considered a loan.

Under section 1(4) of the CIT Act, a loan is a transaction in which a lender gives money to a borrower under a written agreement requiring the borrower to repay that money to the lender in an agreed manner on a specified date. We find that cash pool transactions only partially fit the definition of a loan because they do not usually involve repayment on a due date.

However, from our conversations with the Finance Ministry and from written replies to a number of taxpayers not published on the State Revenue Service's website, we gather that the lawmaker still treats funds transferred to a cash pool as lending, i.e. such transactions are governed by section 11 of the CIT Act.

At the same time, the lawmaker has provided for a number of exclusions where lending to a related party is not a deemed profit distribution and is exempt from CIT. Section 11 of the CIT Act defines three criteria for the lender and five criteria for the loan to exempt it from CIT.

Profit distribution does not include a loan made –

1. by a shareholder to a taxpayer, i.e. by the parent to a subsidiary;
2. by a taxpayer to its permanent establishment abroad; or
3. by a farming/forestry cooperative to its members for business purposes.

Lending to a related party is not treated as profit distribution if –

1. the loan does not exceed what the lender has borrowed from an unrelated party;
2. the taxpayer's balance sheet at the beginning of the financial year shows no retained earnings;
3. the loan does not exceed the taxpayer's registered share capital at the beginning of the year less any unrepaid loans, except those mentioned at 1, 4 and 5;
4. a loan for up to 12 months;
5. a loan made by a taxpayer with social entity status.

As we wrote earlier, there are two types of cash pools: physical and notional. This raises the question of whether there are any differences in their CIT treatment.

The CIT treatment of a physical cash pool

Since this type of cash pool physically combines funds of multiple group companies, i.e. members transfer their funds to the cash pool, it is treated as related-party lending and may attract CIT unless one of the exemption criteria is met.

One of those exclusions is a loan for a period not exceeding 12 months. In our view, this criterion best fits a cash pool – the companies' balance in a cash pool usually changes constantly as it is increased by incoming cash and reduced by payments to creditors. But the problem is that the amount of loan cannot be measured. In our view, the only way to tell if a company has any taxable item is by comparing its cash pool balance at the beginning and end of the financial year. If the closing balance in the cash pool account is higher than the opening balance and if the credit turnover in the cash pool account is lower than the opening balance, the 12-month criterion does not apply and there is taxable item. In this situation, the tax base can be calculated as any positive difference between the cash pool balance at the beginning of the year and the credit turnover in the cash pool account, thereby measuring the amount of funds lent for a period exceeding 12 months.

If a cash pool does not meet the 12-month time limit, then one of the other statutory exclusions may be taken to exempt the funds from CIT.

The CIT treatment of a notional cash pool

This type of cash pool enables group companies to consolidate their balances from multiple accounts to obtain a better interest rate, with no physical movement of money to the cash pool, i.e. title does not pass to the cash pool keeper, and we do not, therefore, believe this can be considered a loan.

Accordingly, in our view, taking part in a notional cash pool does not create a taxable item.