

17.6: Global Money Management- Moving Money across Borders

Learning Objectives

1. Understand the role of global money management in a multinational firm.
2. Know how multilateral netting and transfer pricing can be used to minimize transaction costs and taxes for the firm.
3. Appreciate the efficiencies and savings that result from centralized depositories.

Global Money Management and Centralized Depositories

Global money management involves moving money across borders and managing the firm's financial resources in a way that minimizes taxes and transaction fees while maximizing the firm's returns.

A multinational company can make the most of its cash reserves by holding cash balances at a central location, called a **centralized depository**. There are two main advantages of centralized depositories:

1. The company earns a higher interest on higher amounts of cash, because cash from across the company is pooled.
2. Pooling cash reserves reduces the total amount of cash that the company needs to hold, because the amount of cash held on hand as a precautionary measure against the unexpected can be pooled and thus reduced—it's unlikely that all the worst cases will happen simultaneously.

Centralized money management also lets a company trade currencies between its subsidiaries and thereby eliminate intermediaries like banks. This practice saves the firm transaction costs. Centralization also means that the company can buy currencies in larger lot sizes, which gives it a better price.

Two facts are important to keep in mind when using the centralized depository technique for global cash management. First, a government can restrict how much capital can flow out of the country (governments do this to preserve foreign exchange reserves). Second, there are transaction costs associated with moving money across borders, and these costs are incurred each time the money is moved.

Cash Management

Companies need to be aware of differences in local cash practices. For example, business customers in Asia often pay their invoices via bank draft—a common method there, but almost unheard of in the United States. This approach typically means a company gets its cash slowly, creating potential working-capital problems. "If you sell to a customer on 30-day terms and on day 29 they give you a bank draft, that's three months more you'll have to wait," said Brian Kenny, CFO of specialty chemicals materials company W. R. Grace's Asia-Pacific division. Don Durfee, "Local Knowledge," *CFO*, November 1, 2008, accessed August 12, 2010, www.cfo.com/printable/article.cfm/12465219.

Multilateral Netting

Multilateral netting is a technique which companies use to reduce the costs of cross-border payments between subsidiaries. Three or more subsidiaries must participate. (If only two participate, the technique is known as bilateral netting.)

For example, let's say a firm's subsidiary in the Czech Republic owes the Australian subsidiary \$4 million, while the Australian subsidiary owes the Czech subsidiary \$10 million. Rather than the Czech subsidiary transferring \$4 million and the Australian transferring \$10 million, the parties agree to one payment in which the Australian subsidiary pays the Czech \$6 million. Both payments are thus satisfied. The total funds that flowed between the subsidiaries are reduced from \$14 million to \$6 million, reducing costs. For example, if the transaction costs (i.e., the foreign exchange commission plus the transfer fees) are 1 percent of the total funds transferred, the transaction costs in this example drop from \$140,000 to \$60,000. In cases where multiple subsidiaries trade amongst each other, the savings are even more significant. For example, if four subsidiaries each trade with three other subsidiaries, the total number of transactions can be reduced from twelve to three, which reduces transaction costs substantially.

In a real-life example, Colgate-Palmolive operates in 218 countries. Much of its manufacturing operations are centralized rather than being located in numerous countries around the world. As a result, subsidiaries do a lot of business with each other. Colgate headquarters requires that all subsidiaries submit and settle their payments to each other on the same day. By directing all settlements to one day, Colgate maximizes the benefits of multilateral netting and saves on the spread. This reduces the transaction

costs as well as the risk of currency fluctuations. Kabir Masson, ““Managing International Financial Risk’: A Presentation by Hans L. Pohlshroeder,” *Columbia Business School Chazen Web Journal of International Business*, February 24, 2009, accessed November 23, 2010, www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/3386/Managing%20International%20Financial%20Risk%20Epdf.

Did You Know?

According to a survey of almost five hundred CFOs and controllers from US-based companies, the following are the top concerns regarding international taxes:

- Cost of complying with international taxes (31 percent of respondents)
- Transfer pricing (28 percent)
- Repatriation of offshore earnings (21 percent)
- Risk management in developing countries (14 percent)
- Mergers and acquisitions transactions (5 percent) Marie Leone, “Tax Sticklers, Not Schemers,” *CFO*, May 26, 2010, accessed October 28, 2010, www.cfo.com/printable/article.cfm/14501223.

Tax Advantages of Fronting Loans

A **fronting loan** is a loan made between a parent company and its subsidiary through a financial intermediary such as a bank. The advantage of using fronting loans as a way to lend money, rather than the parent lending the money directly to the subsidiary, is that the parent can gain some tax benefits and bypass local laws that restrict the amount of funds that can be transferred abroad. With a fronting loan, the parent deposits the total amount of the loan in the bank. The bank then lends the money to the subsidiary. For the bank, the loan is risk free, because the parent has provided the money to the bank. The bank charges the subsidiary a slightly higher interest rate on the loan than it pays to the parent, thus making a profit.

The tax advantages of fronting loans come into play if the loan is made by a subsidiary located in a tax haven. A **tax haven** is a country that has very advantageous (i.e., low) corporate income taxes. Bermuda is a well-known tax haven. The bank pays interest to the tax-haven subsidiary. The subsidiary doesn’t pay taxes on that interest because of the tax-haven laws. At the same time, the interest paid by the subsidiary receiving the loan is tax deductible.

Transfer Pricing

Multinational firms that conduct business among their cross-border subsidiaries can use tax-advantageous transfer pricing. Transfers occur when a company transfers goods or services between its subsidiaries in different countries. For example, a firm might design a product in one country, manufacture it in a second country, assemble it in a third country, and then sell it around the world. Each time the good or service is transferred between subsidiaries, one subsidiary sells it to the other. The question is, what price should be paid? The **transfer price** is the price that one subsidiary (or subunit of the company) charges another subsidiary (or subunit) for a product or service supplied to that subsidiary.

Since the pricing taking place is between entities owned by the same parent firm, there’s an opportunity for pricing an item or service at significantly above or below cost in order to gain advantages for the firm overall. For example, transfer pricing can be a way to bring profits back to the home country from countries that restrict the amount of earnings that multinational firms can take out of the country. In this case, the firm may charge its foreign subsidiary a high price, thus extracting more money out of the country. The firm would use a cost-plus markup method for arriving at the transfer price, rather than using market prices.

Although this practice optimizes results for the company as a whole, it may bring morale problems for the subsidiaries whose profits are impacted negatively from such manipulation. In addition, the pricing makes it harder to determine the actual profit which the favored subsidiary would bring to the company *without* such favored treatment. Finally, all the price manipulations need to remain compliant with local regulations. In fact, to combat such potential losses of income tax revenue, more than forty countries have adopted transfer-pricing rules and requirements. “Driving Indirect Tax Performance—Managing the Global Reform Challenge,” KPMG, April 2010, accessed October 28, 2010, www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Pages/Driving-indirect-tax-performance-Global-reform.aspx.

Generally, compliance with local tax regulations means setting prices such that they satisfy the “arm’s length principle.” That is, the prices must be consistent with third-party market results. The test of fairness is, “What would an independent company, operating in a competitive market, charge for performing comparable services or selling similar products?” Alfredo (Jay) Urquidi and David

R. Jarczyk, “The Importance of Economics in the Practice of Transfer Pricing,” *Transfer Pricing International Journal*, May 26, 2010, accessed November 23, 2010, www.ceterisgroup.com/files/Articles/Urquidi-Jarczyk-Economics_May10.pdf.

Nonetheless, even within these guidelines, multinational firms can adjust prices to shift income from a higher-tax country to a lower-tax one. Governments, of course, are instituting or revising legislation to ensure maximum taxes are collected in their own countries. As a result, multinational firms must monitor compliance with local transfer-pricing regulations. Alfredo (Jay) Urquidi and David R. Jarczyk, “The Importance of Economics in the Practice of Transfer Pricing,” *Transfer Pricing International Journal*, May 26, 2010, accessed November 23, 2010, www.ceterisgroup.com/files/Articles/Urquidi-Jarczyk-Economics_May10.pdf.

Indirect Taxes

One way that governments respond to budget shortfalls is by imposing or increasing **indirect taxes** like the value-added tax (VAT) and goods-and-services tax (GST). The reach of these indirect taxes is extending into new areas of the global economy. “The slow economy and falling direct-tax rates are causing many governments worldwide to tighten their existing indirect-tax regimes or introduce new ones,” said Frank Sangster, a principal in KPMG’s US Indirect Tax practice. “Finance and tax directors must be proactive in considering how their organizations are responding to the global VAT changes, which are already affecting their markets, operations and internal systems.” “U.S. Multinationals Expected to Feel Impact of Accelerated Global Move to VAT,” *SmartPros*, May 3, 2010, accessed October 28, 2010, accounting.smartpros.com/x69387.xml.

More countries are coming to rely on VAT as a significant and stable source of tax revenue, so these taxes are unlikely to diminish. China and India are considering introducing national VAT systems for the first time, while European Union (EU) countries might be looking at ways to raise more revenue through VAT. International companies can assess and manage the risks and opportunities of new VAT systems by using merging technologies to increase automation of the indirect tax process, deciding whether to insource or outsource new compliance obligations, and using modeling techniques to assess the impact of local VAT changes. “U.S. Multinationals Expected to Feel Impact of Accelerated Global Move to VAT,” *SmartPros*, May 3, 2010, accessed October 28, 2010, accounting.smartpros.com/x69387.xml; “Driving Indirect Tax Performance—Managing the Global Reform Challenge,” KPMG, April 2010, accessed October 28, 2010, www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Pages/Driving-indirect-tax-performance-Global-reform.aspx.

Manufacturing shoes in China for the Chinese market is subject to a 17 percent VAT, for example, but shoes for export aren’t subject to this tax. In some cases, it may be cheaper to make the shoes in China, export them to Hong Kong, reimport them into China, and pay import duties instead of VAT. Local import/export regulations can also impact where companies decide to locate specific functions of the supply chain, such as distribution centers or warehouses. In Fujian province, one can import materials one day and export the output the next day. In Guangdong province, in contrast, the local authorities insist on thirty days’ notice for reexported materials. The point is that each emerging-market country and even each region in an emerging-market country can have its own interplay of taxes, duties, and regulatory delays that affect how companies design their operations and the margins they’re able to achieve.

Did You Know?

Colombia and Indirect Taxes

To attract business process outsourcing (BPO) vendors to Colombia, the country eliminated the VAT tax on BPO service exports. This makes it more attractive to locate offshoring services in Colombia. Local governments also created two free-trade zones in Bogotá and Medellín specifically for BPO, providing state-of-the-art infrastructure and services to companies that settle there. Luis Andrade and Andres Cadena, “Colombia’s Lesson in Economic Development,” *McKinsey Quarterly*, July 2010, accessed August 14, 2010, www.mckinseyquarterly.com/Economic_Studies/Productivity_Performance/Colombias_lesson_in_economic_development 2642.

KEY TAKEAWAYS

- Global money management involves moving money across borders and managing the firm’s financial resources in a way that minimizes taxes and transaction fees while maximizing the firm’s returns.
- Companies can use multilateral netting as a way to reduce the costs of cross-border payments between subsidiaries. They can also use fronting loans to gain tax advantages.
- The transfer price is the prices at which subsidiaries or affiliates of the same firm sell goods or services to each other. When subsidiaries are located in countries with different tax rates, opportunities exist to move income to a lower-taxing jurisdiction. Firms can manipulate transfer prices to reduce global tax liabilities.

- A multinational company can make the most of its cash reserves by holding cash balances at a central location, called a centralized depository, thus earning higher interest and being able to reduce the total amount of cash reserves held on hand. However, the two downsides of centralized depositories are that governments can restrict how much capital flows out of their country and transaction costs are incurred each time money is moved across borders.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. How can local cash practices in a country affect a subsidiary's cash flow?
2. What are some advantages that multinational firms gain from centralized depositories?
3. Explain multilateral netting and how it can reduce transaction costs.
4. Why would a company choose to do a fronting loan?
5. What are the challenges of transfer pricing?

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