

# Structured approach

**NICK FARMER** and **STEVE HOARE** look at international tax issues on expanding abroad.

There is always a new statistic causing further concern about where the UK economy is heading. Consequently, in an uncertain economic environment, many small and medium-sized enterprises (SMEs) are looking at overseas markets as a key pillar of their future strategy, not just to grow but also as a means of maintaining the status quo.

This article is aimed at helping businesses that are looking to take their product or service into a new overseas territory for the first time. It discusses some key international tax issues that need to be considered to ensure that the correct steps are taken and costly mistakes are avoided.

Companies have to take into account a multitude of tax issues when expanding overseas, and it is useful to adopt a structured approach for working through them. One tactic is to base the advice around three key areas of impact, namely:

- Structure and tax attribute management. This involves assessing the most appropriate structure for the overseas operations and the tax attributes of the country in which the company is seeking to operate.
- Trading and profit management. This requires the identification of how the profits arise within the various territories and ensuring that tax efficiency is optimised within the operations.
- Finance and cash management. This requires advising on the tax issues that arise from funds being transferred or located overseas and how they are returned to the shareholders.

These issues are interlinked, and visually shown in **Key areas of impact**, and provide a framework for delivering the tax advice required by the SME.

## Structure and tax

It can be a daunting prospect for a business venturing into an overseas market for the first time. An initial step may involve

### KEY POINTS

- Managing VAT and customs duty.
- Explore local tax issues.
- Setting up an overseas branch or subsidiary.
- Transfer pricing arrangements.
- Bringing profits back to the UK.



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having no overseas presence whatsoever, but instead consist of distance selling the product or service from the UK base.

At this stage, the principal tax risk will be to ensure that VAT and customs duty obligations are properly managed. As these are transactional taxes it is very easy for a business to overlook these in its eagerness to begin shipping goods. Overseas withholding taxes also need to be assessed before finalising contractual arrangements, as these can cause an unexpected impact on cashflow or even increase the total tax burden. For instance, some of the UK tax treaties, such as that with Pakistan, provide for fees of a technical, managerial or consultancy nature to be taxed in the country of which the payer is resident.

Once a business has assessed that an overseas market is receptive to its product or service, it may wish to enhance its presence in a particular territory. The business will need to identify how to structure its operations, as well as appreciate how local taxes will impact on the business. It can be beneficial to explore specific aspects of the local tax system such as:

### KEY AREAS OF IMPACT



- tax rates, including state and local taxes;
- the tax base and deductibility of expenditure;
- incentives, such as tax holidays and free zones;
- loss utilisation and other tax reliefs;
- local VAT or sales taxes; and
- compliance obligations.

The classification of any proposed business vehicle should be assessed from both a UK and local tax perspective. Entities can be viewed differently by each taxing authority. For example, the US limited liability company is treated as a pass-through in the US but, in line with the recent decision in *CRC v Anson*, is viewed by HMRC as an opaque corporate entity.

In general terms, the decision from a UK perspective will be whether to operate as a branch of the UK company or to incorporate a local subsidiary. Some advantages of each structure are set out in *Overseas structures*.

## Overseas branch

When conducting business in an overseas territory, it is important to determine the extent of the tax obligations that will arise. Where operations are being carried out in a treaty country, the treaty definition of permanent establishment (PE) can be considered to determine if the UK company has created an overseas direct tax presence.

Experience shows that in some cases the threshold for establishing a PE can be very low indeed. For example the provision of services to a customer in India can, in certain circumstances, create an Indian PE for a UK business if those services are performed for more than 90 days in India. Each treaty should be separately reviewed as the PE definitions and thresholds vary.

The new UK/China treaty introduces the concept of a 'service PE' which will result in a PE being created if services, including consultancy services, are provided for a period exceeding 183 days in total over a 12-month period. If the assessment is that no PE is created in the territory in question, this should be reviewed as and when changes occur so that the PE risk is proactively managed.

In a move towards a more territorial corporate tax system, the tax treatment of overseas branches has changed with the introduction of the branch exemption in FA 2011, Sch 13. The exemption, in broad terms, will enable a UK company with an overseas PE to make an election to exempt the profits of the PE from UK tax.

The branch exemption will therefore be particularly attractive where the overseas territory applies a lower rate of tax to profits than the UK. However, the election is irrevocable, and will also result in the losses of the company's overseas branches no longer being capable of relief against the profits of the UK company. For small companies, the exemption will only be relevant if the PE is in a full treaty country.

The location of assets, functions and risks is important for businesses looking to elect into the new branch exemption regime. However, a common down-side of operating as a branch is that an exercise to attribute results to the PE can be tricky. This can be particularly awkward where the period for which the PE exists differs from the accounting period of the UK entity, or the accounts are drawn up on a different basis as can be the case in Russia, for example.

## OVERSEAS STRUCTURES

### Branch advantages

- Lower set-up and running costs.
- Use of overseas tax losses.
- No shareholding considerations.
- Limit associated companies.
- Easier to wind up.
- Can be incorporated if appropriate.

### Subsidiary advantages

- More substantial presence.
- Commercial liability ring-fenced.
- Easier profit determination.
- Access local tax advantages.
- Controlled repatriation of profit.
- Tax efficient exit.

## Overseas subsidiary

An overseas subsidiary will often be the preferred business vehicle, both for tax and for commercial reasons. Although it is often the case that the subsidiary can be 100% owned from the UK, this may not always be possible due to local restrictions, e.g. China restricts investment into certain industries which necessitates a joint venture arrangement with local partners.

**“An overseas subsidiary will often be the preferred business vehicle, both for tax and for commercial reasons.”**

Different tax treatments may also arise locally depending on the nature of the shareholders, such as in Singapore, and profit extraction and exit planning should also be contemplated at this stage. It may also make sense to establish a holding company above the UK and foreign subsidiary companies, as this can assist from a financial and risk management perspective.

The tax residency of the overseas subsidiary will need to be carefully considered, and management and control from the UK will result in the company being deemed to be tax resident in the UK. In such a situation it would be necessary to examine the 'tie-breaker' clause in the appropriate tax treaty to determine the tax residency of the company. HMRC's *International Manual* at paras INTM120130 to INTM120170 provides guidance on when the Revenue will not normally review residence, which can be a useful reference point when assessing residency.

## Trading and profit

Interlinked with the structuring of the operations will be a need to understand how the activities of the business are going to be conducted in the overseas territory and where the profits

are going to arise. There are lots of areas for discussion and review, and the most pertinent will depend on the nature of the business. Key aspects to consider include:

- employee movements;
- transfer pricing arrangements;
- withholding taxes; and
- anti-avoidance legislation.

## Employee movements

It is often the case that existing UK employees are seconded to the overseas operations. The income tax and National Insurance position of the individual then has to be considered, both from a UK and an overseas perspective. The outcome of the consultation on the introduction of a statutory residency test which closed on 9 September 2011 is likely to determine the future residence status of UK workers when they leave the UK to work abroad. It seems likely that the tax position will be influenced by the period of time that the worker spends in the overseas territory and the number of factors that connect them back to the UK.

## Transfer pricing

One of the key challenges faced by a UK company that has set up an overseas subsidiary will be to ensure that it is compliant with its transfer pricing obligations under corporation tax self assessment. The detailed rules are now found within TIOPA 2010, Part 4 and, while there are exemptions for SMEs (as defined) from a UK perspective, the company needs to be mindful that the transfer pricing rules applying to the overseas entity are unlikely to be governed by a similar exemption. Therefore, however small the company may be, foreign tax authorities, such as the Internal Revenue Service in the USA, will expect to see documentary evidence to support the transfer pricing arrangements that are put in place.

Transfer pricing arrangements should be actively considered for intra-group transactions between the UK company and its subsidiaries. The relevant areas for consideration fall under the following headings:

- intra-group services;
- tangible property;
- intangible property; and
- finance.

Ensuring that all transactions are identified and transfer priced can result in a considerable improvement in the group's overall international tax burden. Areas often overlooked include shared services and the use of intellectual property. The introduction of the patent box in 2013 will be relevant to intellectual property planning for groups that have qualifying patents registered by the UK Intellectual Property Office or the European Patent Office.

## Withholding taxes

Trading overseas requires the business to observe the peculiarities of each relevant foreign tax system. This is important in relation to the withholding taxes that can arise. Vodafone's acquisition in India

## FUNDING ALTERNATIVES

### Loan capital

- Reduces profits in high tax territory.
- Extraction of funds simpler.
- Thin capitalisation rules can apply.
- Foreign exchange concerns arise.
- Flexibility to convert into share capital.
- No capital or stamp taxes usually arise.

### Share capital

- Maximises profits in low tax territory.
- Restriction can be imposed on debt finance.
- Improves commercial image.
- Access dividend exemption regime.
- Commercial simplicity.
- Minimum share capital often required.

is an extreme case in point. It can be expected that each country will have different rules for registering and minimising local withholding taxes, and UK companies need to avail themselves of these rules since only the minimum tax payable overseas is capable of credit relief in the UK. For instance, when trading with, or in India, companies should consider registering for a permanent account number to minimise the local withholding taxes.

## Anti-avoidance

The application of the controlled foreign company legislation and how this relates to each overseas subsidiary is likely to be of concern. This legislation is essentially aimed at artificially diverted profits to protect the UK tax base. It applies where the subsidiary is resident outside the UK, controlled by persons resident in the UK, and the tax on its profits is less than 75% of the corresponding UK tax on those profits. For instance, a company that expands its operations into a low tax territory, such as Dubai, will have to consider how this legislation will impact on its UK tax position.

The legislation has been a primary cause of a number of high profile corporate migrations from the UK. In response, over the past four years, the government has consulted business with the intention of improving and modernising the legislation. This has resulted in interim improvements to the controlled foreign companies rules being introduced in FA 2011 ahead of the full reform which is expected to be finally delivered in Finance Bill 2012. The interim legislation has resulted in four new exemptions being introduced for accounting periods beginning on or after 1 January 2011. As might be expected, the rules are detailed and need to be worked through, but as long as profits are not being artificially diverted from the UK, and result from genuine economic activity undertaken overseas, no controlled foreign companies apportionment should arise.

## Finance and cash

If a subsidiary is to be incorporated, a further decision that should be taken at a relatively early stage will be how to fund it. The main choice will be between debt and equity. **Funding**

**alternatives** illustrates some of the relevant considerations arising from using these forms of finance.

Debt funding may come from the UK company by way of an inter-company loan or it may be obtained from a financial institution such as a bank. Some banks may be unwilling to lend into a newly incorporated entity without a track record in that jurisdiction, so funding may need to come directly from the UK company itself. The UK company will need to decide on the currency of funding and appreciate the tax implications of the exchange gains and losses that will arise. Withholding taxes will also need to be considered, and these may be reduced under a relevant treaty or eliminated under the Interest and Royalties Directive (03/49) on interest payments between certain EU companies.

## Repatriation of profit

The aim of any business expanding overseas will be to make a success of the venture with the result that profits will be realised and, if not initially, at some point, repatriated back to the UK. There are various routes that can be used including dividends, royalties, interest, inter-company service charges or trading transactions. Local regulations will need to be assessed, and the most appropriate method of profit extraction will depend on the circumstances. In China, trading transactions can represent an easier way to extract profit, although all transactions must be on an arm's length basis.

Since 1 July 2009 inbound dividends have been governed by the rules set out in CTA 2009, Part 9A. A complexity here arises from the fact that the legislation is based on the premise that all inbound dividends are taxable unless exempt. Dividends paid to small

companies can only be exempt if they are paid from a company resident in a territory with which the UK has a treaty with an appropriate non-discrimination clause. Medium and large groups have a different set of rules as laid out in Chapter 3 of Part 9A which provide for exemption where the distribution falls within one of five exempt classes, unless anti-avoidance rules apply.

Withholding taxes on the outbound dividend from the overseas subsidiary should also be clarified, with the exact terms of the dividend article in an appropriate treaty needing review. For instance, to access the lower 0% rate of the US/UK treaty, 80% or more of the voting power of the company is required to be held for a 12-month period ending on the date that the dividend is declared. Where the overseas company is in a country that is a member of the EU, the Parent/Subsidiary Directive (90/435) can enable withholding tax to be eliminated if the conditions are met.

## Conclusion

As more companies than ever look to overseas markets to expand their businesses, the tax issues inherent in the process need to be considered by their advisers. There will never be a one size fits all method, and different companies will undoubtedly have different issues, but taking a structured approach to the advice should keep the tax surprises locked away. ■

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# TAXATION