TAX CONSIDERATIONS FOR UK TECH COMPANIES

US GUIDE

Department for Business & Trade

MADE IN THE UK SOLD TO THE WORLD

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Department for Business & Trade

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INTRODUCTION

UK technology companies often desire to engage in transactions in the United States or with US counterparties. Those transactions may take several forms and include: (1) hiring US talent and engaging in operations in the US, (2) licensing technology to US companies and/or individual users or (3) offering services or products to customers in the US. In addition, UK technology companies - particularly companies in their start-up phase - may also want to attract venture capital from US investors.

There are myriad tax considerations, both US and UK, to consider with respect to these cross-border transactions. This paper identifies certain US tax considerations relevant to these transactions.

This paper is a general summary and is not intended to provide legal advice. Accordingly, if you have any specific questions about the contents of this paper and its applicability to your particular circumstances, you should consult your own tax advisor or the Wilson Sonsini directory of attorneys.

US TAXATION OF US PERSONS

US persons (as determined for US federal income tax purposes) are subject to US federal income tax on their worldwide income at graduated rates. US persons include individuals who are citizens or residents of the US or who are physically present in the US for a certain number of days as well as corporations (or entities treated as corporations as described in the paragraph below) created or organized under the laws of the US, any US state or the District of Columbia. Accordingly, a US corporate entity will generally be subject to US tax on its entire net income, whether US-sourced or non-US-sourced, even if the subsidiary is exclusively managed or controlled by UK persons.

Entity Tax Classification

Under the entity classification regulations, commonly referred to as the 'check the box' regulations, US legal entities with one owner may be treated as either (1) a corporation subject to tax at the entity level or (2) a disregarded entity that is generally ignored for US federal income tax purposes. An entity organized as a state law corporation is always classified as a corporation for US federal income tax purposes, whereas an entity organized as a limited liability company (or 'LLC') will be treated as a disregarded entity by default, unless the LLC elects to check the box as a corporation by filing an appropriate election with the US tax authority—the Internal Revenue Service (or 'IRS'). If an entity is disregarded, all of its activities and income are treated as owned and derived by its owner. Thus, a UK company that does business in the US through a single-member LLC will be directly subject to US income tax on the income derived from that US business (as further described below) unless an election is made to treat the LLC as a corporation for US tax purposes, in which case the LLC would be subject to US federal and state income tax. The US subsidiary may also be subject to additional state or local taxes, including income, sales and use, and/or property tax, which may be material. A discussion of these items is beyond the scope of this paper.

US TAXATION OF NON-US PERSONS

Non-US persons, such as UK limited companies, generally are not subject to US federal income taxation unless the person, directly or indirectly, (1) is engaged in a US trade or business, (2) receives certain US-sourced income (i.e., ‘fixed or determinable annual or periodic’ income or ’FDAP income,’ including rents, royalties, interest and dividends) or (3) receives a narrow category of US-sourced capital gains.

US Trade or Business
If a UK company conducts trade or business within the US directly, the UK company will generally be subject to US federal income tax on net income that is effectively connected with its US trades or businesses at the same graduated rates applicable to US companies. The company may also be subject to an additional branch profits tax at a rate of 30%. Such income must be reported to the IRS by filing a US federal income tax return.

Whether a UK company is engaged in a US trade or business generally depends on a highly factual inquiry into the nature and extent of the company’s economic activities in the US. Due to the rapid growth and development of new technology, the application of existing US international tax principles to technology and internet businesses (e.g., businesses with online advertising, cloud computing, or data storage operations) is not entirely clear. For example, under current US tax law, the performance of cross-border electronic services, such as creating or updating software for a US end-user, should be treated as establishing a US trade or business only if the employees performing such services are physically present in the US, although this is an area that is rapidly evolving. The location of a company’s servers in the US may also weigh in favour of finding a US trade or business.

UK companies should also be aware that they may be imputed the activities of persons deemed to be their ’agents’ for US tax purposes. Whether an agency relationship exists depends on the nature of the person’s activities and the relationship between the person and the company. For example, a UK company may be treated as engaged in a US trade or business if it contracts with a related or unrelated person that regularly performs services in the US on the company’s behalf. Additionally, as indicated above, a UK company that conducts business in the US through a wholly owned LLC is generally treated as directly conducting the LLC’s US trade or business (unless an election is made to treat the LLC as a corporation).

However, if the UK company is entitled to benefits under the US-UK income tax treaty, its income from its US trade or business would be taxable in the US only if the company (directly or indirectly through its LLC) has a ‘permanent establishment,’ i.e., a fixed place of business, in the US for purposes of the treaty. A UK company may generally avoid having a US permanent establishment if it conducts its transactions with its US clients through brokers or other independent agents acting in the ordinary course of their business. Conversely, a UK company will usually be treated as having a US permanent establishment if it has a dependent agent that has, and habitually exercises, the authority to conclude contracts in the US that are binding on the company. As such, UK companies should be careful of how they draft their contracts with third parties to avoid being imputed a US trade or business and establishing a US permanent establishment.

US-Sourced Income Not Effectively Connected with a US Trade or Business
Certain FDAP income not effectively connected with a US trade or business is generally taxed on a gross basis at a 30% rate (or a lower rate under an applicable income tax treaty). FDAP income encompasses almost all income, including dividends, royalties, interest and income from the performance of services, but excludes capital gains (each described more in detail below). This tax is withheld and remitted to the IRS by the payor of the income.

However, many types of interest income are exempt from FDAP withholding, including interest arising from registered debt (or ‘portfolio interest’). Additionally, depending on the type of income, a UK company may be entitled to lower or zero rates under the US-UK income tax treaty. To establish its eligibility for such lower
or zero rates, the UK company must provide the payor with a properly completed applicable IRS withholding form (e.g., IRS Form W-8BEN-E).

US-Sourced Dividends
Under the US ’double taxation’ regime, earnings of a US corporation are first taxed at the corporate level at the corporate income tax rate (currently, 21% federal) and taxed again at the shareholder level when distributed as dividends. Because dividends are sourced in the payor’s country of incorporation under US tax law, UK shareholders may be subject to 30% FDAP withholding unless they qualify for a lower treaty rate under the US-UK income tax treaty (currently, 5% for shareholders who own 10% or more of the payor by vote, and 15% for all other shareholders). As such, a UK company doing business in the US through a US corporate subsidiary may be subject to an approximate 25% US federal income effective tax rate on its US earnings (in addition to the state and local corporate income tax rates).

US-Sourced Royalties
UK companies will often licence or sell their software or other intangible property to US companies for use in the US. Under the US-UK income tax treaty, “any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including computer software and cinematographic films) including … any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience” is treated as royalty income, and under US law, sourced in the country in which such intangible property is used. For this purpose, contingent gains—i.e., gains that that are contingent on the productivity, use or disposition of the property are treated as royalty income rather than capital gains. As such, income generated from such licensing or sale arrangements is generally treated as FDAP subject to 30% withholding. However, if the US-UK income tax treaty applies, the UK company would be subject to zero percent US withholding (unless the UK company is related to the US payor and the royalty payments exceed the arm’s length price as determined under US transfer pricing principles, as further described below).

US-Sourced Income from the Performance of Services

Income from the performance of services is generally sourced to the country in which the services were performed. Under US law, it is generally understood that this rule requires physical presence, which means UK companies that service their US clients or customers remotely with no service providers physically present in the US should not be subject to US tax on income generated from those services.

Embedded Intangibles and US Transfer Pricing Principles

UK companies should be aware that income generated from the performance of services may need to be recharacterized if the services are embedded with intangible property. For example, if a UK company agrees to develop a technological device for a US client but retains rights to use the underlying IP, a portion of the payments made in return for the service may be recharacterized as royalty income. This may not be significant for UK companies that qualify for treaty benefits, since income from royalties and performance of services outside the US generally are not subject to US taxation. In the context of intercompany transactions, however, ’embedded intangibles’ are a more important issue.

Under US transfer pricing principles, if an intangible is transferred between a parent and its subsidiary in return for a lump sum payment, such payment must be “commensurate with the income attributable to the intangible,” which means the IRS could retroactively determine the proper ’arm’s length’ price of the intangible based on the actual income derived from the intangible. As such, if a UK company’s US subsidiary develops IP and licences this IP back to the UK parent in return for a lump sum payment that, in hindsight, undervalues the IP in light of the profits that are actually generated by the IP, the IRS may recalculate the income received by the US subsidiary with respect to that lump sum payment and thus retroactively increase the amount of taxes owed by the US subsidiary.

US-Sourced Capital Gains

Capital gains not effectively connected with a US trade or business generally are not subject to US federal income tax unless they are attributable to a sale or exchange of ‘US real property interests,’ which include interests in US real estate or US corporations that hold a certain amount of interests in US real estate. The US-UK income tax treaty does not provide for a lower or zero rate for such gains.

Considering the complexity of the above rules, UK companies looking to conduct business in the US through a US office, branch or subsidiary, employees, or other related or unrelated parties should consult a US tax advisor to determine whether their activities may be subject to US federal income tax and/or give rise to any US tax filing obligations.

US PFIC REGIME FOR UK VENTURE-BACKED COMPANIES

VALUE ALL ITEMS

UK technology companies looking to attract US investors should be familiar with the US PFIC regime. If a UK company is a passive foreign investment company (or 'PFIC'), gains recognized by a US investor on its sale of the company's shares is taxed at the higher ordinary income rates (currently, up to 37%), rather than the lower preferential capital gains rates (currently, up to 20%). The US investor may also have to pay 'interest' on a portion of the tax, based on the underpayment rate (currently, approximately 7%). Because this hefty tax liability could potentially erase a US investor's return upon exit, US investors typically avoid making equity investments in companies treated as PFICs, heavily negotiate for terms to ensure that the company would not be treated as a PFIC during the investment period or insist that the company cooperates in making a QEF election, as described below.

What is a PFIC?

A PFIC is any non-US corporation that meets either the ‘income test’ or ’asset test.’” A corporation meets the income test if 75% or more of its gross income is passive (e.g., interest, dividends, related-party royalties, etc.). The asset test is generally met if 50% or more of the company’s assets produce passive income (e.g. cash, real estate, securities, etc.). For this purpose, cash is generally treated as a passive asset although there are certain exceptions for cash held as working capital if certain requirements are met.

The PFIC regime was created primarily to discourage US persons from investing through foreign corporations in passive investments, not active businesses. However, without proper tax planning, non-US companies— particularly, non-US startups—may inadvertently become PFICs. For example, a computer software startup not yet able to deploy its cash contributions and whose product is only in its initial stages of development may not pass the asset test, since its cash may be too substantial in relation to the value of its IP. Moreover, although the asset test is usually measured based on the fair market value of the startup’s assets, the asset test as applied to a company that is a ‘controlled foreign corporation’ (or ’CFC’) is measured based on the company’s US tax basis in its assets. Since most startups do not have a significant amount of basis in their IP and typically have a significant amount of cash from fundraising, a startup that is a CFC is much more likely to be a PFIC.

A UK corporation will generally be treated as a CFC if more than 50% of its voting power or value is owned by shareholders who are US persons (as defined above) that own 10% or more of the corporation’s voting power or value, after applying certain attribution rules. Although the PFIC rules do not apply to the 10% US shareholders, they would continue to apply to the other US shareholders. For this purpose, a UK shareholder may be treated as a US person if he or she is physically present in the US for a certain number of days during a particular period.

As such, UK startups looking to avoid PFIC status should minimize the amount of cash they have on their balance sheets at any given time. Pre-revenue startups should also consider keeping their cash in non-interest-bearing accounts. Additionally, founders should consult with a US tax advisor before moving to the US for any length of time, to avoid being treated as a US person and causing their startups to become CFCs.

Because PFIC status is measured on an annual basis, even if a startup is not currently a PFIC, US investors—particularly US venture capital investors—typically insist on including in financing agreements a representation that the company is not a PFIC and covenants that the company will take good faith efforts not to be a PFIC, will determine its PFIC status annually, and will provide the information required for US investors to make a QEF election. The QEF election mitigates the investor’s PFIC tax liability but can be made only if the company agrees to provide the investor with an annual report of the investor’s share of the company’s earnings and profits (as determined for US tax purposes). Such requests can require significant ongoing monitoring and analysis and should be done by a qualified US accounting or law firm.

A UK company interested in attracting US investors should thus consult its US tax advisor to discuss the implications of the PFIC regime.

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