

Negotiating the US tax system

Daniel Cassidy makes sense of the challenges facing UK companies

The opportunities for increasing profits through expansion into the United States are vast for savvy UK companies, but dealing with the monstrosity that is the US tax system has its challenges. It is true, the US tax system is complicated. It consists of a complex federal tax system and hundreds of state and local tax jurisdictions, each offering its own menu of income, franchise, sales, estate and gift taxes. However, with proper planning and advice, sense can be made of it and, with that, the rewards of the US market can be realised.

Get advice early and choose the appropriate structure

Many businesses interested in working in the United States make the mistake of waiting until they have established their business before getting advice. This can be very expensive in the long run. It is imperative to choose the right structure from the beginning, as once the structure has been chosen, it is often costly to change. While contemplating the type of structure to adopt, the business should consider several factors – current and future, as well as general and specific to either the United States or UK operations. What is the impact on current taxation? Are start-up losses deductible? What are the plans for repatriation of profits? And what is the ultimate exit strategy?

There are several entities to choose from – branch operations, limited liability companies (LLCs), partnerships or C corporations (a C corporation is subject to corporate level tax, as opposed to partnerships and LLCs which are generally taxed on a flow-through basis). The most common approach for UK companies is to house their US operations in a C corporation. This is the simplest choice and often does not cause significant tax problems. There are times, however, when the use of an alternative structure



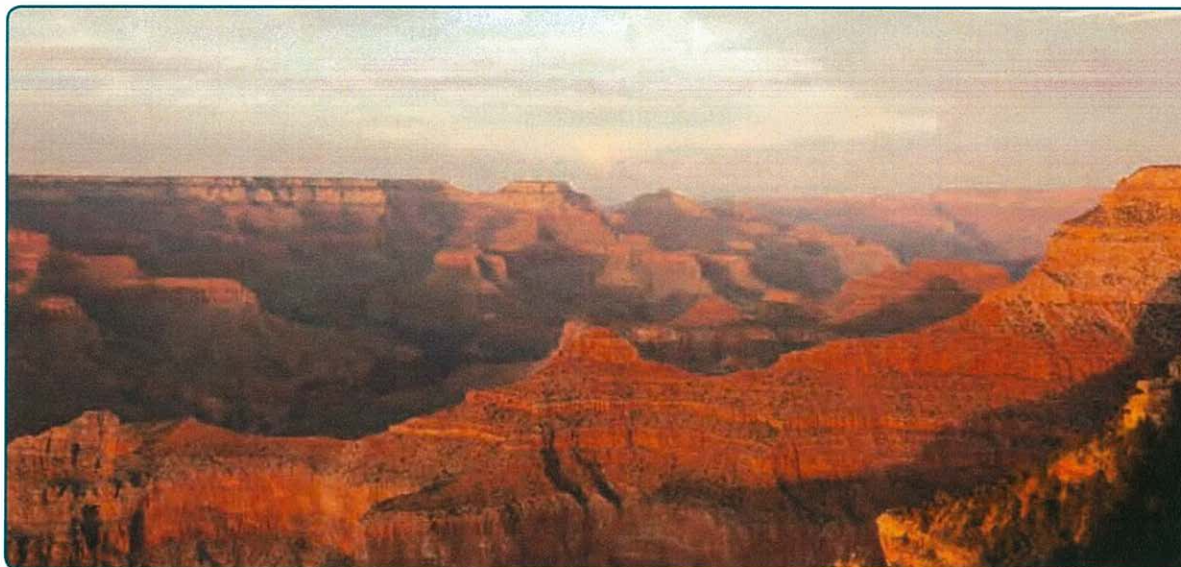
can result in important tax savings. In these situations, partnerships and LLCs are used to create hybrid entities that are taxed either on the basis of flow-through for US purposes and as corporations for UK purposes (a 'hybrid entity') or as corporations for US purposes and on the basis of flow-through for UK purposes (a 'reverse hybrid entity').

Once the structure has been chosen, what taxes will be levied?

The United Kingdom and United States benefit from a treaty that governs when UK businesses become subject to US federal income taxes. A UK company's business income is not subject to US income taxes unless the business is conducted through a 'permanent establishment' in the United States. A permanent establishment will generally consist of a fixed place of business located in the United States, although certain other activities, such as having employees or dependent agents habitually approving contracts in the United States, may also result in a permanent establishment.

Once a UK company has a permanent establishment in the United States, it will become subject to federal income taxes. That is, its US business income will be subject to income taxes in line with US companies. It is at this point that UK companies often establish a US subsidiary.

The UK-US Income Tax Treaty does not apply to state and local taxes in the United States. Therefore, for the purposes of these taxes, the permanent establishment provisions do not apply. In their place are the state nexus rules, which vary from state to state. These rules determine when a company will become subject to taxation in a particular state. In general, a UK company will become subject to state income taxation if it has employees performing services in the state, owns tangible property located in the state, or owns intangible property that is being used in the state. This often results in a situation in which a UK company is exempt from federal tax by virtue of the treaty, but is still subject to state and local taxes. This commonly occurs where a UK company owns property or inventory located in the United States.



It should also be noted that, while the treaty may exempt a UK company from US federal taxation, it will typically not exempt it from its US tax filing requirement. Most UK companies that have regular sales to customers located in the United States are required to file an annual tax return – even if they are exempt from US taxation under the treaty. The purpose of this filing is to notify the IRS that a treaty exemption is being claimed.

Capitalisation options – debt versus equity

If a UK company decides to establish a US subsidiary, it must determine what mix of debt and equity should be used in the capital structure. All things considered, many businesses will choose equity over debt. This choice is not always intuitive. In general, businesses can get a better tax result by using debt instead of equity (this is because the use of debt allows for the repatriation of profits via tax-free principal payments and deductible interest payments, as opposed to non-deductible dividend payments). But the use of debt is not without risk. To achieve the desired tax benefits of debt financing, the US corporation must be adequately capitalised, the debt instrument must bear interest at market rates, and borrowing terms must be otherwise commercially reasonable. If these conditions are not met, the IRS may reclassify the debt as equity and unexpected negative tax consequences may arise.

Given the risk and complexities associated with these rules, companies will often choose to use equity instead of debt.

The foregone tax advantages are often a small price to pay for the simplicity and certainty that results from the use of equity.

Beware of the transfer pricing rules

Transfer pricing rules pose one of the most challenging issues for companies doing business internationally. These rules are designed to protect the tax base of countries like the United States and the United Kingdom, and essentially require that any transactions between related companies take place at an arm's length price. That is, the amount charged in a given transaction has to be equivalent to what two independent parties would charge each other under the same circumstances. For example, if a US company is a distributor for a UK manufacturer, the UK company may sell the goods to the US company for resale by the US company, or the US company may sell the UK company's goods and earn a commission. In either case, the sale price of the goods or the sales commission paid must be the same as that for an arm's length party under similar contractual terms.

US transfer pricing rules are similar in many respects to UK rules. Often, the substance of the analysis is the same under both US and UK law; however, US rules require very specific documentation and impose significant penalties for failure to comply. Therefore, it is important to consider both the substance and the form when complying with these rules.

Tricky state tax issues

State and local taxes are not covered by the UK-US income tax treaty. Thus, even if

a UK firm is exempt from federal income taxes because it doesn't have a permanent establishment in the United States, it could be subject to tax under various state, city and other local tax regimes – each with its own array of income, gross receipt, franchise, sales and use taxes.

The two most common types of state and local taxes are income taxes and sales taxes. Income taxes are imposed on companies with activities in the state and are based on net taxable income. Income tax rates generally range from 0 to 10 percent. Sales taxes are consumption taxes that are generally imposed on the purchase or use of goods in a particular state. Sales tax rates also generally range from 0 to 10 percent. While the ultimate taxpayer is the consumer, businesses are required to register, collect and remit sales taxes to the state or local government. Failure to comply will generally result in the seller being liable for the tax. Most states impose both an income and sales tax.

There is no doubt that there are significant challenges that UK companies will face when doing business in the United States. But Americans love to spend, and that creates plenty of opportunities for UK companies. For those intent on taking advantage, early planning and expert execution could lead to significant business success.

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