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Tax Talk

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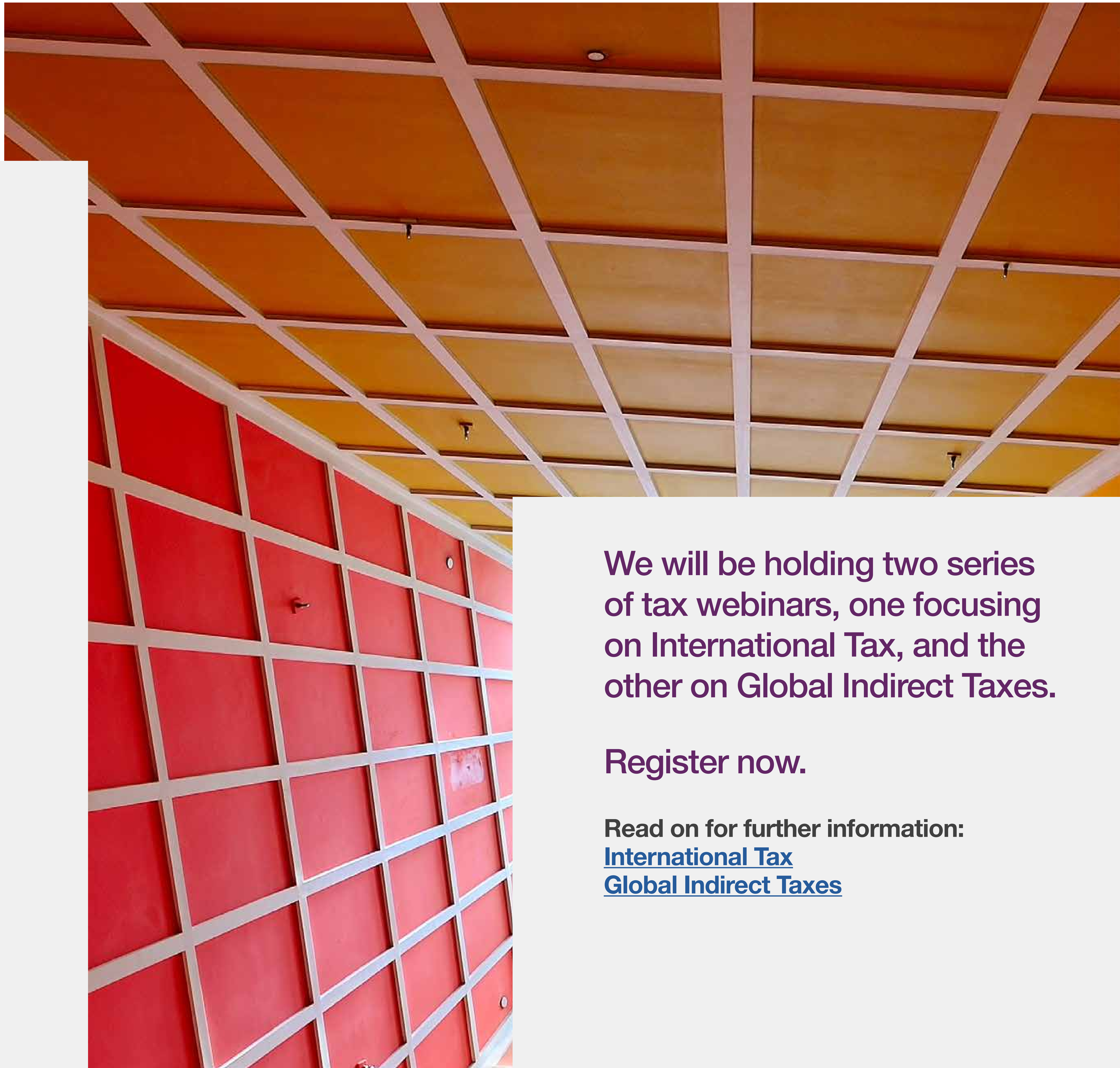

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Doing business in the US through an LLC: UK tax pitfalls

UK companies and resident individuals conducting business in the US often do so through a US limited liability company (LLC). But there are uncertainties for UK taxpayers. Jonathon Collins and Tom Golding explain.

An LLC is a common business form in the US and does provide some benefits. But mismatches can arise between US and UK tax treatments. There can also be tax inefficiencies when UK residents hold an LLC as an investment.

What is an LLC?

An LLC is a type of business entity available in all US states. It is a hybrid: part statutory corporation and part partnership. The UK has various forms of partnerships and companies, as does the US, but there is no direct equivalent to an LLC in the UK. This makes it difficult to determine the UK tax treatment of LLCs, an uncertainty not resolved by the UK/US Double Taxation Agreement (DTA).

What are the LLC benefits from a US perspective?

An LLC can provide some benefits compared to a US statutory corporation (or Inc.), including:

- an LLC, by default, is a transparent entity for US tax purposes and its profits are taxed as if it is a partnership (so taxed on its owners) - this means business profits can be taxed just once as opposed to an Inc., whose profits are taxed at the corporation level and again when distributed to its owners
- a less formal management structure
- greater flexibility for LLC members to allocate profits and losses amongst themselves (other than per their capital contributed)
- enhanced protections from external creditors

So what's the problem?

Under the UK/US DTA, UK residents are entitled to receive credit for US tax against any UK tax "computed by reference to the same profits, income or chargeable gains". But HM Revenue & Customs (HMRC) usually regards an LLC as an opaque, not a transparent, entity and generally denies claims for US tax credit relief against the UK tax liabilities of LLC owners.

In 2015 the UK Supreme Court held that a UK resident, Mr Anson, could claim credit for US taxes he paid as a result of his membership of a Delaware LLC. HMRC maintained Mr Anson should pay US

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Large business compliance: what you need to know

tax on his allocated LLC profit share, as well as UK tax on distributions from the LLC - without any credit for US tax. Although HMRC lost this case, it did not change its general approach and says the decision was “specific to the facts found in the case”.

Uncertainties for UK taxpayers

When a UK company owns a US LLC as part of a group, HMRC generally treats the US LLC as an opaque entity, with no tax credit relief available to the UK company. This is not usually a problem if distributions fall into one of the exempt categories. Even when a UK resident individual owns an LLC, as in the Anson case, HMRC says claims for tax credit relief will be considered on a case by case basis. Individuals wanting to use an LLC and claim US tax credit relief should take legal advice with a view to mirroring the agreements in Mr Anson’s Delaware LLC. But they must be prepared for a challenge by HMRC.

Electing for corporate treatment

As we’ve said, an LLC is by default a transparent entity for US tax purposes. But under US law an LLC can elect to be taxed as a corporate (or opaque) entity. Although this option doesn’t mean HMRC will allow a claim for US tax credit relief, it could result in reduced US taxes. That means it could benefit UK resident members of existing LLCs.

UK anti-hybrid rules

For UK corporate entities, distributions from LLCs will often be exempt from UK tax. But there are other factors to consider.

An LLC that is transparent for US tax purposes but treated as opaque for UK tax purposes will fall within the definition of a hybrid entity for the purposes of the UK legislation relating to Hybrid and Other Mismatches. Payments made from an entity within the charge to UK corporation tax to an LLC may result in a counteraction, under these provisions, that denies any deduction for the purposes of corporation tax in the UK.

The UK government has said it intends to make changes to the rules so that certain payments involving US LLCs are not captured by the provisions. This may resolve the situation long-term, but until then there’s still uncertainty for UK corporate taxpayers.

Other UK tax considerations

HMRC acknowledges that LLCs don’t sit comfortably with the UK/US DTA and some of its interpretations and treatments are by concession. So care must be taken when applying the DTA. What’s more, while HMRC generally treats an LLC as opaque, it won’t necessarily treat an LLC as a corporate body having share capital for all UK tax purposes. UK group structures containing LLCs that rely on certain UK tax reliefs are particularly subject to risk and should be carefully reviewed.

Alternative structures

In view of the uncertainty and mismatches that can arise between the US and UK tax treatments of LLCs, UK companies and resident individuals planning to conduct business in the US should take advice to make sure they’re clear about the tax consequences of investing via an LLC. Alternatively, they may wish to consider other structures from a US and UK perspective. But where simplicity and certainty are desired, it may be best to avoid using an LLC altogether.

Share buybacks: getting the best deal

If your company needs to buy back shares for whatever reason, it's worth checking whether you qualify for capital treatment.

It's not uncommon for a shareholder to exit a company by way of a share buyback where they sell their shares back to the company. This could be because there is no suitable external buyer or as part of the company's process to remove a dissenting shareholder.

The default tax position is that this repurchase is treated as an income distribution, subject to Income Tax. However in some cases, it may be possible to treat the disposal as a capital transaction for tax purposes, which would be subject to Capital Gains Tax (CGT).

How do I obtain capital treatment?

To qualify for capital treatment on a purchase of own shares, the company must be an unquoted trading company. The repurchase must fulfil either all of Condition A or Condition B:

Condition A

- The buyback is made wholly or mainly in order to benefit the trade carried on by the company, or a 75% subsidiary. For example, by removing a dissenting shareholder, or to ensure that an unwilling shareholder does not sell their shares to an unacceptable new shareholder. But the condition is not met where the transaction is designed to serve the personal or wider commercial interests of the seller
- It does not form part of a scheme or arrangement which aims to enable the seller either to participate in the profits of the company without receiving a dividend, or to avoid tax
- the seller must be resident in the UK in the tax year of the purchase
- the seller must have owned the shares for at least five years. Holding periods of a spouse are added for this purpose
- there must be a substantial reduction in the seller's shareholding. This means that their interest in the company must be 75% or less of what it was before the buyback. This includes the interests of any associates
- following the buyback, the seller must not be connected with the company. This means they must not own, or be entitled to own, more than 30% of the issued ordinary share capital, loan capital and issued share capital, voting power, or the assets on a winding-up. Interests of associates are included.

Condition B

- the whole, or substantially the whole, of the payment is applied by the seller to discharge their liability for IHT arising on a death, within two years of that death

HMRC offers an advance clearance procedure to clarify its position on the tax treatment of a buyback.

Share buybacks: getting the best deal

Two scenarios

Let's look at an example where the conditions of capital treatment are met:

An individual owns 1,000 £1 ordinary shares in a company, that are fully paid. They will be bought back at £15 per share. The Capital Gain is 1,000 x £15 = £15,000 minus £1,000 = £14,000. This would be liable to tax at either 10% or 20%.

But what if the conditions for capital treatment are not met?

The dividend received will be £14 per share, being the £15 received on the buyback less the £1 subscription price. The total dividend is therefore £14,000. This would be liable to tax potentially at the highest rate of 38.1%, which is due to increase to 39.35% from 6 April 2022.

What about non-tax issues?

Tax is not the only important issue. There are several other key points to be aware of:

- the company must have sufficient distributable reserves to carry out the buyback
- the company must make a full cash payment for the shares. (Note that a workaround via a multiple completion contract is less attractive now that HMRC is restricting the availability of Business Asset Disposal Relief (formerly Entrepreneurs' Relief) with this route)
- any shareholders' agreements or articles of association should be reviewed to check there are no restrictions or prohibitions on buybacks
- there are also company law requirements to appropriately effect the buyback.

Don't forget

If capital treatment is available, you must report the buyback to HMRC within 60 days. Stamp Duty will be payable at 0.5% of the consideration unless the purchase price is £1,000 or less.

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Holding companies – can I get a VAT refund?

HMRC is very strict in considering whether they accept a Holding Company can be considered to be in Business for the purposes of recovering VAT. Holding strong supporting documentation is fundamental.

Traditionally, the activities of a holding company are considered to simply to hold and sell shares in subsidiaries and collect dividends. These are not recognised as business activities for VAT purposes. As a result, a traditional holding company cannot register for VAT, nor recover any VAT incurred on its supplier costs. Holding companies can incur significant costs when structuring a takeover or deciding to list on a stock exchange and the VAT element of these costs can be quite significant. The ability for a holding company to recover this VAT will undoubtedly be hugely beneficial.

When a company is a business

HMRC's default position for a holding company is that it is not in business for VAT purposes. However, in fact many, holding companies have activities beyond passively holding investments, and may be actively involved in day-to-day management or in providing interest bearing commercial loans to their overseas subsidiaries (both of which may be considered business activities).

In such cases, the onus is on the holding company to prove, using documentary evidence, that it is not a traditional holding company and does carry on a business. However, it is not always the case that such evidence has been retained in the correct manner, or the evidence may not support the facts presented. This has resulted in many courtroom battles with holding companies being unable to recover their VAT costs for a variety of different reasons - leading VAT cases such as Polysar (C-60/90), BAA Plc, African Consolidated Resources and so on.

The usual rules

Generally speaking, businesses can register for VAT if they are in business for VAT purposes. That means regularly supplying and charging for goods or services. There are two types of VAT registration – mandatory (because the business exceeds registration thresholds already) and voluntary (where such thresholds are not exceeded, but the Company is nonetheless in business). The VAT registration application form is no different, but HMRC does scrutinise voluntary registration applications more rigorously. This is particularly true when businesses identify that they intend to start trading in the near future but do not have evidence of historic trading as yet. HMRC requires proof of this intention, such as customer contracts, supplier contracts or purchase orders, so that it can be satisfied the business operations are legitimate.

Different for holding companies

The operations of a holding company do require a much higher level of scrutiny. This is because all the parties are related and they may be operating in a sector which have large costs but does not see any immediate profits (such as mining).

HMRC requires that holding companies registering for VAT on a voluntary basis must have evidence that supports the intent to carry on a business – for example - documented management or loan agreements which are commercial in nature. HMRC will want to see invoices being raised to subsidiaries in a commercial manner for which there is an obligation to pay. If the holding company has not yet entered into agreements, HMRC would want to see other evidence (e.g. signed board minutes) that the holding company had an intention to provide such services at the time costs (bearing VAT which is

Holding companies – can I get a VAT refund?

reclaimed) were incurred, and at the effective date of registration. The timing of this evidence determines the date from which a holding company can register for UK VAT – if it is put in place later this would defer the effective date of VAT registration to that later point. Strictly any VAT incurred before this date will not be recoverable. So it is important to get it right.

Small signs of change

In the past HMRC would not approve a holding company VAT registration without first being satisfied with the documentary evidence. However, we have recently seen instances where HMRC approves the VAT registration application but will immediately audit the first VAT return - which would typically have a large VAT refund – and seek the information in that audit - so don't get too excited until the refund hits your bank account.

HMRC will scrutinise the evidence and may well challenge it on the principles established in the leading VAT cases highlighted above. It is therefore important that the agreements/evidences are properly reviewed by a VAT expert so that they are reflective of the commercial reality and meets the relevant criteria. As it will be an intercompany agreement Corporate Tax, Transfer Pricing and Withholding Tax impacts should also be considered.

Ultimately, each case will be different and a balanced approach will need to be considered in light of the facts and the evidence that is available. There is no "one size fits all" solution but recent cases such as Bluejay Mining PLC and Tower Resources PLC have been found in favour of the taxpayer which provides some degree of certainty with respect to recovery of input tax incurred.

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International tax webinar series

We're delighted to invite you to register for a free series of International Tax webinars.

Indirect taxes issues of global trading
25 January 2022

Structuring your international expansion
19 October 2021

Are you thinking of expanding overseas? Have you thought about if you need to form an entity or a branch? If you do where is the best place for it to sit within your group or do you even need one? How will you finance the operation and how will you repatriate funds back to the parent? Join Corporate Tax Partners **Chris Riley** and **Catherine Heyes** as they consider these questions and more.

Watch on demand

International movement and equity incentivisation of your team
16 November 2021

As the world opens up again, join Global Mobility Director **Louise Fryer** and Employment Tax Senior Manager **Dan Kelly** as they discuss some of the challenges that can be presented when a company operates internationally including making sure you have a robust global mobility policy in place, are meeting employer "in country" reporting and payroll obligations and, of course, the tax and social security implications for the individual.

Watch on demand

Indirect taxes issues of global trading
25 January 2022

The movement of goods and services cross border can create indirect tax issues in many countries, which can include the location of your customer. There is an increased focus on businesses that trade online and even for more traditional sectors such as manufacturing, indirect taxes can be complicated especially post Brexit. Join VAT Director **Luigi Lungarella** as he presents three case studies to explore these issues and more.

Register

Global Indirect Taxes Webinars

We are delighted to invite you to register for a free series of Global Indirect Taxes webinars

The series will help you and your organisation navigate the significant changes that have been made to indirect taxes globally and provide an overview of technical and commercial considerations across all key jurisdictions.

Our webinars will also cover e-commerce, cross-border services, the concept of an establishment from a VAT and direct tax perspective, and customs duties. Attendees will be provided with real-world examples of how to minimise cross-border indirect tax issues.

Each event will be led by VAT Director, Luigi Lungarella who will be joined by indirect tax experts from across the PKF International global network, including the USA, Russia and the EU.

Join us for our series of Global Indirect Taxes Webinars:

Session 1 - Global Indirect Tax Update - Watch on demand
Session 2 - 1st December 2021 - Watch on demand
Session 3 - 2nd February 2022 - Cross-border services – navigating local requirements
Session 4 - 6th April 2022 - The servitization of the economy and the importance of establishments
Session 5 - 8th June 2022 - Cross-border goods – The hidden costs and challenges of Customs

About PKF
Simplifying complexity for our clients

PKF is one of the UK's largest and most successful accountancy brands.

We provide a full range of audit, accountancy, tax and advisory services, and are experts at simplifying complexity – we're particularly well-known for working with large, high-profile businesses with challenging issues in fast-moving and highly technical areas.

We are also an active member of PKF International, a global network of legally independent accounting firms that gives us an on the ground presence in 150 countries around the world.

PKF in the UK

9th largest Tax practice in the UK

£165 million annual fee income

2,050 UK partners and staff

6th ranked auditor of listed companies in the UK

Our tax services
At a glance

> "By bringing together the extensive expertise and experience of our tax specialists we can provide a fully rounded service that offers excellent value for money."

We offer comprehensive tax compliance and advisory services to a range of clients, both in the UK and globally, helping them find their way in the increasingly complex world of tax.

We find practical solutions that we use to our clients' advantage. Our team of experts supports individuals, and businesses ranging from start-ups and SMEs to large international groups, both listed and privately owned.

Where understanding of our clients' sector makes the difference, our experts invest their in-depth industry expertise to provide invaluable support and insights.

We offer the following specialist tax services:

Corporate and business taxes

Our Business Tax team will ensure that you are both tax compliant and efficient.

We provide specialist corporate and business tax advice on both a local and international level, which includes senior accounting officer and large business compliance, transaction services, due diligence, R&D tax relief, employer solutions and global mobility. We also support both the personal and business affairs of partnerships and LLPs.

Read more

Personal tax and wealth management

Our team will guide you through the complex world of taxes, helping you meet all filing requirements and identifying risks and opportunities to help mitigate tax liabilities.

We advise individuals, the self-employed, partners, trustees and executors with their UK and international tax affairs. Our services include all aspects of tax, including Self Assessment, Capital Gains Tax, Inheritance Tax, property (both residential and commercial), trusts, family wealth and estate planning, residence and domicile issues.

Read more

VAT and Indirect taxes

Our indirect tax team will support you in meeting your VAT compliance objectives and advise you on any VAT issues that your business faces.

We can ensure that your VAT risk is assessed and managed, and that your VAT recovery is optimised. We can also provide advice and compliance services on other indirect taxes, such as Insurance Premium Tax, Customs duty, and Air Passenger Duty.

Read more

Tax disputes

HMRC is increasing the number and scope of tax investigations into both individuals and businesses, covering all aspects of potential underpayments of tax, including offshore investments, personal and corporate Self Assessment Tax Returns, PAYE and NIC compliance and VAT.

If an issue arises, our trusted advisors will match the right specialists with your needs to provide you the necessary support – whether for a routine HMRC enquiry or a more complex investigation.

Read more

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