Practice guide

UK tax pitfalls of the foreign company

Speed read

There are several bear-traps for a foreign company proposing to do business in the UK other than through a UK establishment, including three tax regimes introduced during the last five years. Does the foreign company have a UK permanent establishment and, if not, could it be caught by the diverted profits tax's 'avoided PE' rule? Does it receive income from intangibles that may be subject to the new regime taxing offshore receipts? Separately, if it provides digital services to UK users or supplies goods in the UK, it may find itself in scope of the new digital services tax or liable to UK VAT registration.

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It's easy to dismiss the UK taxation of foreign corporates as arising only if a company has any real presence in the UK, be it through tax residence or other establishment. In this article, we touch on UK permanent and fixed establishments of companies established outside the UK and highlight some of the key UK tax bear-traps for companies with no such presence (but which nevertheless do business in the UK), including three regimes which have sprung up only in the last five years or so.

Permanent establishments

The traditional notion that only a UK fixed establishment or UK dependent agent (or even, strictly, a UK independent agent acting outside its ordinary course of business) can give rise to a UK permanent establishment is currently being tested by developments in international taxation, in particular as regards the digital economy. However, given that we should know more on that from the Organisation for Economic Cooperation and Development (OECD) only by year-end (if that, given that rumour has it that the OECD's target of reaching political agreement on policy aspects has been postponed from July to October for Covid-19 reasons), we do not consider in this article any proposed changes to the meaning of 'permanent establishment'.

As readers will be aware, new rules effective 6 April 2020 bring into charge to UK corporation tax rental and other income received by non-UK resident companies from UK property business. This change, together with the extension of UK taxation to chargeable gains arising from direct and indirect UK real estate disposals and the UK taxation of dealing in or developing UK land, are not considered further in this article and we focus instead on businesses unrelated to UK real estate.

Corporation tax

In order for a non-UK resident company to have a UK permanent establishment for UK corporation tax purposes (and thereby be subject to UK corporation tax if the non-resident carries on a trade in the UK through that permanent establishment, per CTA 2009 s 19(1)), CTA 2010 s 1141(1) provides that:

(i) the foreign company must have a fixed place of business in the UK through which that company's business is wholly or partly carried on; or
(ii) an agent acting on behalf of the foreign company must have, and habitually exercise, in the UK authority to do business on behalf of the foreign company (if the agent is independent, it must not act in the ordinary course of its business) (the 'dependent agent' test).

In each case, merely preparatory or auxiliary activities (which are not fragments of a wider business) do not count.

Although there may be disputes as to the finer factual detail, the existence in the UK of a place of management, branch, office, factory, workshop, mine, quarry or building site, for example, is pretty well understood – these are physical things that we can touch and feel. The existence therefore of a 'fixed place of business' in the UK through which the business of a foreign company is wholly or partly carried on (limb (i) above) should be relatively familiar. Note that HMRC has given comfort (in its *International Tax Manual* at INTM 261010) that the temporary stranding in the UK of employees of a non-UK resident company during the Covid-19 pandemic should not, in and of itself, create a UK permanent establishment although this is less because of any specific relaxation of UK rules and more simply because the existing rules require a degree of permanence in order for a 'fixed' place of business to exist.

The existence, however, of a dependent agent (limb (ii) above) is often considerably murkier, particularly given the complex arrangements for oversight and input rights by the principal (the foreign company) often put in place for robust non-tax reasons to ensure that a UK agent (acting for and on behalf of the foreign company) delivers on its mandate in any given case whilst continuing to exercise the skill and expertise for which it was engaged as agent in the first place.

For example, it is not uncommon – particularly for valuable supply contracts – for a foreign company which is embarking on UK business either from scratch (a new entrant to the UK market with, perhaps, a successful

existing business overseas) or through acquisition of an existing UK business (think transitional services arrangements) to seek the help of a person already on UK turf, at least for the immediate few months until it gets its feet under the table and has the wherewithal to operate without outside assistance.

The contract may stipulate, for instance, that the UK agent may organise its service provision as it sees fit in certain circumstances whilst being required to obtain input from the foreign company in others; that the UK agent must act on instruction from the foreign company, but only where reasonably required in order for the agent to provide the relevant services; that certain actions require the foreign company's written consent; or that provision of the services will be overseen by a committee, the make-up of whose members may be weighted in favour of either the UK agent or the foreign company, or the final decisions of which may be made through the casting vote of a representative of either party.

Such limb (ii) cases can be borderline, but even with a conclusion that, on balance, factually no dependent agent exists (and thus there is no UK permanent establishment to render part of the foreign company's profits subject to UK corporation tax), the foreign company is not home and dry, for there is a raft of other UK taxes which must still be considered.

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Diverted profits tax

One may mistakenly think that diverted profits tax (DPT) is an obscure tax targeted only at the most egregious tax planning. However, HMRC has reported that since the introduction of DPT in 2015 it has secured over £4.6bn in additional revenue thanks to the tax (including indirect revenue such as VAT from business restructuring and corporation tax where DPT helped to settle investigations), suggesting that it is a key weapon in their 'crack-down on unacceptable planning' armoury to which they are likely dedicating significant resources.

As a general rule of thumb, where any structure even tangentially touches the UK (and especially in borderline permanent establishment cases), a DPT analysis should be considered.

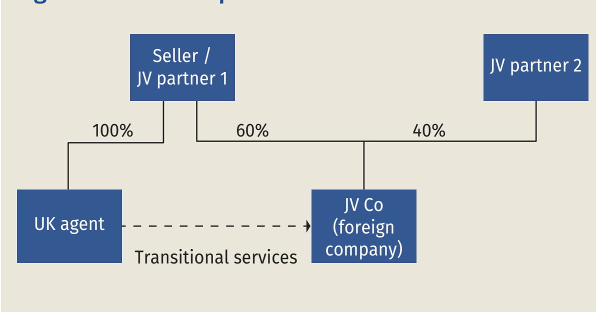
FA 2015 s 86 is highly relevant here, and the foreign company may be in scope of DPT where it could reasonably be assumed that activities are designed so as to ensure that the foreign company does not, as a result of the activities of another person (the 'avoided PE'), carry on a trade in the UK through a UK permanent establishment.

If one can be confident that no such activities have been so designed (maybe this could be personally vouched for; otherwise, for those in private practice, client confirmation should be sought), this may provide comfort enough to rely on that one line of defence and move on.

A more rigorous approach, however, would be to seek to fall within clearer exceptions, such as the £10m threshold for UK-related sales revenues below which DPT can be ignored (FA 2015 s87), or the independent agent (acting in the ordinary course of its business) exception (FA 2015 s 86(5)), commonly deployed in collateralised loan obligation (CLO) transactions through application of the independent investment manager exemption.

Unfortunately, application of the independent agent exception is less clear-cut in more bog-standard (non-CLO) UK agent arrangements, and a closer look needs to be taken at any connection between the foreign company and the UK agent. Thanks to Covid-19, we are already seeing what once might have been outright sales converting to sales of part only, meaning that joint ventures are becoming increasingly common as purchasers struggle to obtain funding and require sellers to keep skin in the game, and this issue is brought into sharper focus. For example, the independent agent exception will be denied outright in the context of a 60:40 joint venture (JV) where the JV is the foreign company and the seller retains a 60% interest and provides (or procures the provision by a member of its group of) UK agency services for a transitional period until the JV can stand on its own two feet. This is because, in addition to the UK agent being independent and acting in its ordinary course of business, the foreign company and the UK agent must not be connected (within the meaning of CTA 2010 ss 1122 and 1123). See figure 1.

Figure 1: DPT example



As a last resort (to be avoided like the plague), one may end up having to get into the weeds of the 'mismatch condition', the nub of which is the existence of a 'material provision' which is imposed between the foreign company and any other person connected to it. The first step here is to identify the material provision under which, broadly, cash is extracted from the foreign company (not equity or debt so, if anything, likely to be an intangibles licence or management services agreement).

If the material provision results in an increase in tax payable by the other person (say on royalties or management fees) of at least 80% of the reduction in tax payable by the foreign company (in respect of those same payments), the foreign company need look no further.

The rules around this calculation are complex but suffice it to say that it is not enough simply to check the corporate tax rates in the jurisdictions of the foreign company and the counterparty (typically the foreign company's parent). One must also take into account, for example, tax depreciation applying in the parent's jurisdiction to reduce its taxable profit insofar as the material provision is concerned.

An analysis based on all relevant facts, with the input of tax specialists in the relevant jurisdictions, really is necessary.

Offshore receipts from intangible property

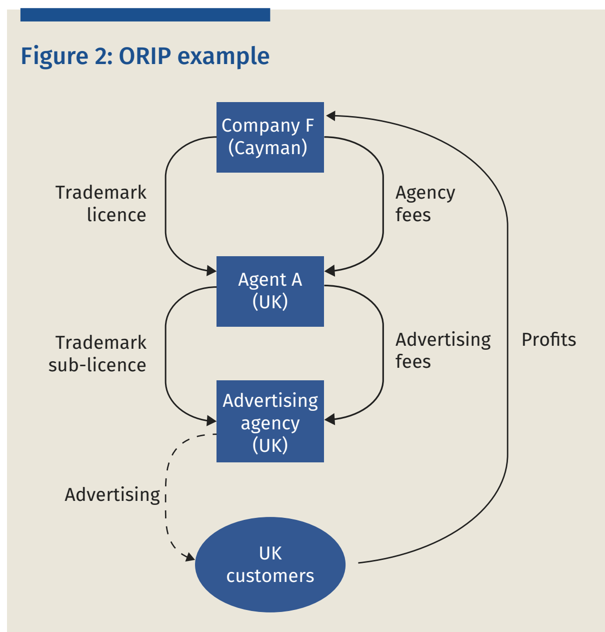
FA 2019 introduced the 'offshore receipts' rules (or, more particularly, offshore receipts in respect of intangible property (ORIP)) in ITTOIA 2005 Part 5 Chapter 2A. The starting point of these rules is a person (in our case, the foreign company) which is neither UK tax resident nor tax resident in a territory with which the UK has a double tax treaty containing a non-discrimination provision (a 'full treaty territory'). Straight away, then, in many cases the rules will be knocked out at the first hurdle given the extensive number of full treaty territories (Cayman Islands, BVI and other exotic islands being obvious exceptions).

If a foreign company is not resident in a full treaty territory, though, it will be within scope of UK income tax under the ORIP rules if it receives an amount (of an income or capital nature) in respect of intangible property which enables or promotes UK sales (that is, services, goods or other property provided in the UK).

Low-value UK sales (sub £10m, much like for DPT) and offshore receipts taxed at least half the notional UK tax or relating to intangible property which is created, developed and maintained at all times in the home territory are out of scope.

But consider a scenario where none of these exemptions apply. Suppose, for example, reverting to our permanent establishment agency example, that an independent UK agent (Agent A) were to use a key trademark of its foreign principal (Company F, which in this example is resident in the Cayman Islands) in order to enable Agent A (an undisclosed agent) to generate sales traction in the UK market of Company F group's products (in this case, organic hand sanitiser and face-masks). Agent A engages an advertiser who then uses the trademark in advertising the hand sanitiser and face-masks in the UK. UK sales sky-rocket, and the profit is passed straight to Company F (Agent A retains and is taxed on its fees, of course). Company F, which is resident neither in the UK nor in a full treaty territory, is in receipt of sums deriving from intangible property which promotes UK sales. As a result, and assuming as above that no exemptions apply, Company F should be liable to UK income tax on the full amount of the receipts. See figure 2.

Figure 2: ORIP example



Withholding tax

In addition to UK income tax 'directly' collected through self-assessment under the ORIP rules, it may also be collected through withholding, for example most obviously in respect of payments of UK source yearly-interest and royalties (including patent, copyright and design royalties). For the avoidance of doubt, the mere investment in UK situs debt and other assets (like the simple holding of UK real estate) does not, in and of itself, give rise to a UK permanent establishment.

If payments to a foreign company are subject to UK withholding tax then consideration should be given to relief under an applicable double tax treaty or, until the end of the Brexit transitional period (expected 31 December 2020), the Interest and Royalties Directive 2003/49/EC (IRD) which has been transposed into the UK tax code. Exemption may also be available for UK withholding tax on interest through the qualifying private placement exemption (QPPE) (ITA 2007 s888A) or the quoted Eurobond exemption (ITA 2007 s 882).

In alternative capital provider (fund) scenarios, relief under the more typical avenue of double tax treaty (and, less popular, IRD and QPPE) is less likely to be available (or to be available in full), meaning that the quoted Eurobond exemption may be the cleanest and easiest way of securing relief, assuming the borrower is on board with the inevitable disclosure and reporting requirements and willing to shoulder the additional cost inherent in a listing.

As a practical matter, a UK withholding tax analysis (like any other tax analysis) should be carried out early, because if a listing is likely to be the only real solution, care needs to be taken to structure the debt as a security from day one, as in our experience few recognised stock exchanges will accept the conversion of bilateral or syndicated facilities into notes.

Digital services tax

The UK is set to introduce its very own digital services tax (DST) which will apply from 1 April 2020 (however fleeting it may be, but then they said that about DPT too). At the time of going to press, the draft DST legislation is under review by the UK Parliament, which is no doubt mindful of the tussles between certain other states in respect of the unilateral introduction of similar taxes outside the UK.

If the rules are enacted as currently drafted, DST will impose a 2% tax on revenues generated from UK users of social media platforms, internet search engines and online marketplaces (in each case, including any associated online advertising services), regardless of the location (and any UK tax presence) of the digital services provider.

The new tax is expected to apply only to groups whose total revenue from any of these digital services is in excess of £500m, and in excess of £25m of that revenue is attributable to UK users, so the threshold is quite high.

Although the UK government has committed to disapplying DST once an appropriate long-term solution is in place (à la OECD reform), the draft legislation provides only that a review of the tax must be conducted before the end of 2025 – so DST could be with us for at least a few years yet and it is another UK tax consideration to feature on our foreign company's UK tax checklist.

Value added tax

Last but not least, we turn to value added tax (VAT) – an altogether different animal from the other taxes referred to above, which has its own rules for determining liability and ultimate cost.

Comparable to, but separate from, the concept of a permanent establishment for UK corporation tax purposes is the concept of the 'fixed establishment' for UK VAT purposes. In relation to any particular supply of services (either made or received), this term is key to understanding where a business person 'belongs' (if that person is otherwise established outside the UK), which is itself key in applying the VAT place of supply rules, which in turn help to identify ultimate liability (if any) to UK VAT of the service in question.

Case law has identified that a fixed establishment must be characterised by a sufficient degree of permanence (not too different then to the corporation tax equivalent), and a suitable structure in terms of human and technical resources, in order to enable it to make or receive relevant supplies.

A fixed establishment of a foreign company may be created by an agent acting for that foreign company and further case law has established that whether an agent in any given jurisdiction can be said to create a fixed establishment of its principal in that jurisdiction depends on the extent to which the agent is dependent on its principal.

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Given the significant overlap between the permanent establishment test for corporation tax and the fixed establishment test for VAT, although there is certainly scope for nuances, in most cases we would expect a UK fixed establishment for UK VAT purposes to exist where a UK permanent establishment exists for corporation tax purposes, and vice versa.

Note importantly, however, that even if no UK fixed establishment of our foreign company exists, the foreign company may (for various reasons) still be required to register and account for UK VAT – yet another instance where a UK establishment is not a pre-requisite for UK taxation.

Indeed, UK VAT registration on the basis of supplies made specifically by a person who is UK-established is provided for under only two of seven schedules to VATA 1994 on UK VAT registration. A foreign company may therefore be required to register and account for UK VAT if, for example, it supplies goods in (or brings goods into) the UK, notwithstanding that it has no UK fixed establishment. Special rules apply in relation to supplies of websites, software, telecommunications, radio and television broadcasting services.

Action points for advisers

- If a company established outside the UK is planning to enter the UK market, in whatever guise, carry out a UK tax analysis early and consider compliance requirements.
- Include in the analysis or structure paper placeholders for corporation tax, DPT, the ORIP rules, withholding tax, DST and VAT (although not set out in this article, the UK taxation of UK real estate may also be a relevant consideration).
- Identify relevant services/assets such as intellectual property, digital services, management services, real estate or finished products which will help to complete the analysis.
- Once any UK tax liability has been identified as applicable in principle, consider the availability of reliefs (including relief for UK tax in the foreign company's home jurisdiction) and ensure contractual documentation is appropriately drafted.
- In the case of a purchase of a foreign company with known UK activities, ensure that the tax warranties in the sale and purchase agreement relating to geographical scope are accurately drafted. Typically, the relevant warranty will state that the foreign company has never been resident for tax purposes or had a permanent establishment outside its home jurisdiction (i.e. the 'conventional' exposures), but this warranty should be widened to apply to 'liability to tax' of the foreign company generally so that DPT, the ORIP rules, withholding tax and, once introduced, DST do not inadvertently fall through the net (VAT usually has its own self-standing warranty). ■

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