FLIPS FROM THE UK TO THE US –
KEY UK AND US TAX CONSIDERATIONS

The insertion of a US holding company by way of a share-for-share exchange, whereby the shares in an existing UK company (“UKCo”) are transferred to a new US company (“USCo”) in exchange for shares issued by USCo, is commonly referred to as a ‘flip’ transaction. A flip transaction is typically contemplated to facilitate raising capital from US-based venture funds. This note highlights some of the key UK and US tax considerations that can be relevant in the context of such a flip transaction.

KEY UK TAX CONSIDERATIONS

Tax Clearances

The flip itself can usually be implemented in a way that results in rollover treatment (and therefore does not trigger a CGT charge at the time of the flip) for UK tax resident shareholders in UKCo. If there are no EIS / SEIS / VCT investors in UKCo prior to the flip, then it is usually recommended (but not a requirement) to seek a pre-transaction tax clearance from HMRC. If there are EIS / SEIS / VCT investors in UKCo prior to the flip, then it is a requirement to obtain a pre-transaction tax clearance from HMRC in order to satisfy one of the conditions for continuity of the relevant relief.

Stamp Duty

It is usually possible for the flip transaction to be structured in a way that is capable of qualifying for relief from UK stamp duty, which (if sought) must be applied for within 30 days following implementation of the flip. However, if there are any plans for any changes to the share capital in USCo following the flip (i.e. as a result of new investments, and/or share transfers), then stamp duty relief on the flip could be denied if such changes could result in a person or persons obtaining control of USCo. It is therefore important to flag any such plans at the outset, so that any structural considerations can be addressed prior to implementation.

Permanent Establishment

In a flip context, if there are existing SEIS / EIS shareholders in UKCo, then typically it would be desirable to have continuity of that treatment in the USCo. If so, as part of the ‘continuity’ analysis, HMRC expects USCo to have a UK permanent establishment. There are a number of practical measures which USCo should implement to satisfy this requirement. We can discuss these with you in more detail, but in summary these include USCo registering a UK establishment with Companies House, USCo having permanent office space in the UK, and USCo having a senior employee working in the UK from the UK office. USCo would be subject to UK corporation tax on any profits of USCo that are attributable to the UK permanent establishment.

Corporate Tax Residence

There is a risk of USCo being tax resident in the UK if the central management and control (“CMC”) of USCo is carried out in the UK. The concept of CMC is derived from case law and HMRC guidance, rather than a specific legislative test. Whether CMC is established in the UK will depend on all of the

facts, and where the key decisions are made, so the location of the key decision-makers when attending board meetings or otherwise making decisions is a key factor.

If USCo were UK tax resident, then USCo would be subject to UK corporation tax on its worldwide profits, and would need to claim credit against double taxation in the UK and the US on the same profits. There would therefore be a risk of double taxation (to the extent that credit is not obtained), and a need for additional filings and administration (including potentially a treaty claim), and possible timing/cashflow disadvantage for the company.

A further, and potentially more significant, reason why it would be recommended not to establish UK tax residence for USCo (even if USCo were not profit-making) is that if USCo is or becomes UK tax resident and subsequently ceases to be UK tax resident, then on such cessation of UK tax residence a UK 'exit charge' could be triggered, resulting in a UK corporation tax liability for USCo based on a deemed market value disposal of any assets held by USCo (which could include intellectual property that is generated or acquired by USCo). So if, for example, USCo were to hold IP or other assets that materially increase in value over such period of UK residence, the liability could potentially be significant.

There needs to be a fact-dependent analysis in each case depending on the location and role of the relevant individuals that are contemplated to be involved in the key decision-making of USCo. We can discuss this with you and provide practical recommendations for how to mitigate the risk within a framework that makes operational sense for your business.

KEY US TAX CONSIDERATIONS

Tax-Free or Taxable

A typical flip transaction is expected to be treated as a tax-free transaction for US tax purposes. However, if the pre-flip owners of UKCo (if it is treated as a corporation for US tax purposes) are exclusively (or even predominantly) non-US investors, and if it is contemplated that any such investors may become US tax residents, consideration should be given to whether it is feasible to structure the flip in a manner that is taxable for US tax purposes (while being tax-neutral from a UK tax perspective). If there are no US investors, structuring the flip as a taxable transaction for US tax purposes can provide the UKCo shareholders with a tax basis step-up in the USCo stock without any adverse US tax consequences to the shareholders or the UKCo. That tax basis step-up could later prove valuable if any of the former UKCo shareholders (*e.g.*, the founders) later become US tax residents.

Qualified Small Business Stock

One of the attractive features for investors in USCo after the flip is the US tax code's Qualified Small Business Stock ("QSBS") exemption. If the numerous QSBS requirements are met, shareholders of growth-stage companies may exclude up to $10 million (or 10 times cost basis, whichever is greater) from US federal income taxes on the sale of shares held more than five years. However, assuming

UKCo and USCo are taxable as corporations for US tax purposes (as is commonly the case), shares of USCo received in exchange for UKCo shares are ineligible for QSBS benefits.

Typically the pre-flip shareholders of UKCo are non-US investors, for which QSBS benefits are generally inconsequential. However, if any former UKCo shareholders are or later become US tax residents, QSBS benefits may become important to them. In that case, additional consideration should be given to structuring the flip to maximize QSBS eligibility for such pre-flip investors.

SAFEs and Other Convertibles

Simple Agreements for Future Equity (“SAFEs”) and similar convertible instruments are popular tools to permit growth-stage companies to raise seed funding in advance of a formal round of equity financing. It should be noted, however, that SAFEs are typically regarded for US tax purposes as equity or stock of the issuing company, which can impact structuring of the flip. For example, a US investor holding a SAFE in the UKCo may want to ensure the flip is tax-free for US tax purposes and may also be concerned about QSBS eligibility of its investment in USCo after the flip. For those reasons, UK companies anticipating a flip into the US should be mindful of US tax considerations when issuing SAFEs and when converting SAFEs to USCo SAFEs or stock in the flip.

CFC and PFIC Considerations

If UKCo has US shareholders, consideration should be given to the US controlled foreign corporation (“CFC”) and passive foreign investment company (“PFIC”) rules in connection with the flip transaction. Generally, UKCo would be considered a CFC if US shareholders that own 10% or more of the equity of UKCo (which, as noted above, generally includes SAFEs), own in the aggregate more than 50% of the equity of UKCo (by vote or value). Special rules may apply to a US shareholder of a CFC that could cause all or a portion of any gain recognized by such US shareholder in a taxable flip transaction to be treated as ordinary income. However, this treatment may not arise if UKCo does not have earnings and profits for US federal income tax purposes.

Additional adverse US federal income tax consequences may arise from a flip transaction to (a) a less-than-10% US shareholder of UKCo if it is a CFC and a PFIC or (b) any US shareholder of UKCo if it is a PFIC but not a CFC. PFIC status is determined annually and UKCo would be considered a PFIC if (i) 75% or more of its gross income for a taxable year is passive income (e.g., dividends, interest, capital gains, rents or royalties (other than rents or royalties from an active trade or business of UKCo)) or (ii) 50% or more of the assets of UKCo (based on a quarterly average of the value of such assets for the year) generate passive income. It should be noted that cash and the stock of a less-than-25%-owned subsidiary of UKCo generally would be treated as generating passive income for this purpose, and the 50% asset test described above must be calculated using the US tax bases of the assets of UKCo, rather than the fair market value of such assets, if UKCo is a CFC. Therefore, if UKCo is a CFC, it also is more likely to be a PFIC.

In a taxable flip transaction, the PFIC rules could cause any gain from the sale of PFIC stock by a US shareholder to be treated as ordinary income for US federal income tax purposes, and could impose an interest charge on such shareholder, unless the US shareholder made a so-called "qualified electing fund" election with respect to such PFIC stock. In a tax-free flip transaction, a US shareholder of a PFIC would have certain US tax reporting requirements.

No Going Back

Although a flip of a UK company into the US can be accomplished with a modest amount of planning, harsh US anti-inversion rules make it difficult, if not impossible, for a US company to flip out of the US. The typical flip structure, if employed in the reverse to create a non-US holding company above an existing US company, would frequently result in the non-US holding company continuing to be treated as a US resident taxpayer for US tax purposes. This treatment would likely undermine, if not vitiate, the business reasons for the flip out of the US. Accordingly, businesses should be very cautious in making the initial decision to flip into the US.

HOW CAN ORRICK HELP?

The specific tax risks and practical recommendations in each case will depend on the particular fact pattern regarding your business and objectives. Please contact us to discuss the UK and US tax implications of your proposed flip transaction with you in more detail.

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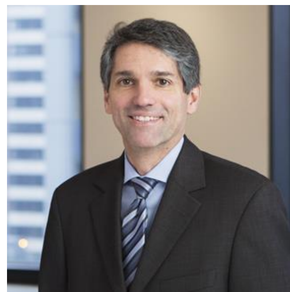

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