Forward thinking
Straight talking

Regrets and retentions

International expansion - avoiding the bear traps

Gateley / LEGAL

As important as the UK is to the world's GDP, according to the International Monetary Fund, it represents just over two per cent of global GDP. The US alone is more than six times bigger[1]. International expansion therefore represents one of the greatest value-creating opportunities for UK businesses.

In pursuit of this opportunity, the effort put into chasing clients, revenue and profits abroad is often not matched by ensuring that the back office keeps up with this expansion. And, as the old saying goes, "what goes around, comes around", which in this case means that if the back office doesn't keep pace with the front office, you can expect things to catch up with you. This is often during a fundraising or sales process, resulting in some regrets, and possibly a retention or two as well.

1 International Monetary Fund (2024) GDP based on PPP, Share of the World. Available at https://www.imf.org/external/datamapper/PPPSH@WEO/GBR?zoom=GBR&highlight=GBR (Accessed 28 November 2024).

"The team at Gateley is extremely capable with excellent off-shore knowledge and experience."

Legal 500 2024

Introduction

With gathering pace after last year's General Election and the prospect of the first Labour Government Budget in over 14 years, the M&A market was rocket-boosted when the date of the Budget was confirmed as 30 October. The rush to complete sales by 29 October reached fever pitch through September and October.

With so many deals lined up to complete by the Budget, many didn't make the finish line in time. However, many deals were well progressed, and efforts continued to close those deals by the end of the year.

One of the many themes that emerged from this busy season was how so many businesses had expanded their operations to new territories, but without keeping pace with the compliance requirements of operating in those new jurisdictions. In a surprising number of cases, this lack of international expansion experience led to many regrets and a considerable number of retentions against potential, likely or almost certain claims against sellers under sale and purchase agreements.

Looking forward, where can companies go about things differently as they prepare for the sale process, or the next round of investment?

Taxable presence

You often see companies first foray into a new territory as a result of following the activities of existing clients. As those clients internationalise, so do some of their suppliers. Another common reason for expanding to a new territory is because as a company's reputation grows and it starts to field enquiries from abroad, it leads to its first 'client win' outside its home country. This is great news for the businesses and bodes well for the opportunities to grow in new markets, but raises lots of perfectly valid, logistical questions: who is going to spend time away to service this new opportunity? How long will they be there? Where will they stay? How often will they make it back to the UK?

In our experience, what is commonly overlooked is an understanding of whether the activities of serving that first client, or in some cases several clients, is sufficient to create a taxable presence in the country. When the due diligence exercise gets into full swing and the questions start coming about the activities in these new territories, there's a scramble to reconstitute records and understand whether tax should have been paid abroad on those international customer wins. Too often, the answer turned out to be "yes it should have been paid" or "probably should have been paid".

Perhaps not surprisingly, a sale of the company doesn't usually follow that first international client success. By the time of the company sale, there are often several countries where this permanent establishment (PE) exposure exists and the group has unwittingly created a PE in more than one country. This leaves the sellers having to navigate a failure to comply with payroll obligations, unfiled tax returns, late payments of tax on the locally generated profits and a need to claim double tax relief to offset the overseas tax against the UK tax already paid.

Tax residence

Commonly, the increasing scale of international opportunities leads to a discussion about whether a new local entity should be set up to house those local operations. At first blush, this is a good thing. It helps to mitigate the risk that the parent company is operating through a PE and has created a non-UK taxable presence. But, who should be on the Board of the new local entity?

As advocates of the old saying "never let the tax tail wag the commercial dog", in answering the question of who should be on that local entity board, we would strongly advocate that those best qualified to carry out the role should be appointed. For many businesses just starting to expand to new territories, it's usually the same people who are responsible for driving the business in the home territory.

If the local entity's key strategic decisions are being made by UK-based individuals while in the UK, it creates a risk that management and control of the local entity is actually being exercised in the UK.

So what? Well, that creates a risk that the local entity might be or become tax resident in the UK, as well as tax resident in its country of incorporation. That creates a whole Pandora's box of issues which again then come out in due diligence. Fixing dual residence is not easy and can be expensive, possibly crystallising an exit tax charge.

Even if you have UK-based directors of the new local entity, it should be possible to operate in a way that minimises or eliminates the risk of the local entity becoming dual resident. Operating by some clear guidelines, and keeping well-documented evidence of sticking to those guidelines should enable you to run the local entity effectively and avoid the dual residence elephant trap. Or, to put it another way, it's a lot easier to set up a system for how you operate a non-UK entity so that you avoid arguments as to its residence than it is to unpick the problem in the heat of a deal. Choosing not to get it right at the get-go will definitely lead to some regrets and likely a retention too.

Sales taxes

It can be quite common for people to make some assumptions that the way it works at home is broadly mirrored in other countries. That can be a reasonable place to start for some issues.

However, taking a UK mindset to the tax system in other countries — the US in particular — can be a very expensive leap. Nowhere is this truer than when it comes to sales taxes. This is a minefield, even for US companies.

It is the poster child for starting a new operation abroad and accruing problems for the future. Sales tax compliance is both complex and expensive. It is, however, a cost of doing business in the US and getting it right from the outset is a lot less burdensome than trying to remediate the problem retrospectively.

As we sought to complete transactions at speed before the tax changes that most people rightly feared would be introduced by the Budget, the impact of poor sales tax compliance came up time and again. The non-compliance was not really arguable. Sellers were left with few options but to agree that the unreported and unpaid sales taxes were to be treated as a debt-like item in a locked box or completion accounts. This often included the costs of correction which, post-deal, sometimes meant a second adviser overseeing the corrective action on behalf of the sellers, adding to the cost and disruption.

It won't always be possible to fix everything before a deal, but it should be possible to stop the non-compliance and start to address the previous issues so that the corrective cost of the previous non-compliance is kept to a minimum. Otherwise, sellers face having to deal with the argument that the price adjustment should include the maximum amounts due, including penalties, interest and duplicated costs of professional oversight on behalf of both the buyer and sellers.

Withholding taxes

The UK has a relatively benign regime when it comes to withholding taxes. We have the benefit of an extensive network of double tax treaties, a limited number of taxes in respect of which withholding tax is applied and no withholding tax on dividends. The same cannot be said of other jurisdictions.

Going back to the main themes that we observed in the race to complete deals at high speed pre-Budget, a failure to withhold tax on payments across borders was common. When you get used to not having to worry too much about a subject because all of your payments are within a single jurisdiction, it can be too easy to miss this when opening up in new geographies, many of which impose withholding taxes on payments of interest, royalties and even fees for technical services. Withholding taxes is a particularly painful area to unpick after the event. One reason for that is that there are two sides to the debate; the withholding tax that should have been remitted to a tax authority and the credit for the recipient.

On one level the problems are navigable, but the complexity comes in the context of an M&A deal from how to make sure that if or when the credit arises, it is available to the sellers to mitigate the final tax bill split between the two jurisdictions. Or to put it the other way round, what's the best way to prevent the buyer gaining a windfall benefit?

Transfer pricing

For decades, multinational corporations have played a game of financial chess, shifting taxable income across borders to minimise tax liabilities. At the heart of this strategy lies transfer pricing. While designed to ensure fair taxation, transfer pricing rules have instead become a battleground of conflicting regulations and mounting compliance burdens.

Mismatches between the transfer pricing rules in different jurisdictions create tax headaches. Take a UK incorporated company that qualifies for an exemption from transfer pricing rules, on the basis it is a small or medium-sized enterprise. Its foreign counterparty, however, operates in a jurisdiction where no such exemption exists, resulting in a compliance nightmare.

While the UK entity may not be required to make transfer pricing adjustments, the counterparty could still be subject to them, leading to tax mismatches, double taxation and potential disputes. With no global standard, businesses operating across borders will continue to bear the brunt of these inconsistencies.

"Gateley are very responsive and give concise advice in easy-to-understand language. They have an excellent ability to distill legal issues into commercial considerations."

Chambers 2025

Directors' emoluments

This may come as a surprise given the amount of legislation in this area but if you thought there was little room to get this wrong, you would be surprised.

This is especially true with directors' emoluments where the directors are operating in more than one country. This is exacerbated by the ever-growing appearance of non-UK based directors providing their services through personal service companies.

Too often, entrepreneurs are advised to keep their annual tax bills down by routing payments through personal service companies and simply not complying with the UK's laws on directors' remuneration, probably because it's such a specialised area of tax and easier to get wrong than right.

For decades, tax due diligence reports have highlighted profit "extraction" as a high-risk area and identified specific activities that lead to price chips, specific indemnities and retentions. It has become clear that this area of focus in due diligence reports has more of an international flavour these days. It was bad enough unpicking this in one country, but to do so cross-border is often quite an expensive and painful process.

Prevention is better than cure, and early treatment is better than crisis management

As the world of healthcare shifts its emphasis from cure to prevention, our recommendation when establishing new operations abroad is to take advice on how to establish your new overseas operations correctly to avoid problems and prevent the issues arising in the first place.

Having said that, if you are looking to sell your business and may not have got everything right, it would be better to look for a cure today, before you get to the due diligence stage of a sale. Fixing these problems in the middle of a transaction is a very unsatisfactory process. It creates friction between buyers and sellers, it distracts the sellers from running and growing the business, it leads to sub-optimal outcomes in terms of overall costs and liabilities and delays or sometimes jeopardises the deal entirely.

If you think that some of these common problems may apply to your company, please let us know. We can do more to alleviate the problems in advance of a sale process than in the heat of the deal. And if you're about to embark on your first foray in international expansion, we would be delighted to help you navigate that journey safely.

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