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Brexit: The Consequences for International Tax Planning

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Just over a month has now passed since the referendum in which the United Kingdom voted narrowly to leave the European Union: an event which some have characterized as the greatest potential shock to the UK economy since the Second World War. For most multinational groups considering the potential consequences of Brexit on their tax position, however, the best advice is probably the same as that provided by the famous wartime poster: “Keep Calm and Carry On.”

While much remains to be resolved about the United Kingdom’s exit from the European Union, what has become clear is that it will not happen quickly. The Government has stated that it will not serve formal notice of its intention to leave the European Union before the New Year, which will start a period of negotiation that, under the European Union Treaty, is anticipated to take two years. The United Kingdom is thus likely to remain an EU member state until at least 2019.

Brexit will almost certainly result in some changes to the United Kingdom’s tax landscape, and these may well cause complications for some multinationals. However, the UK Government is keen to show that the United Kingdom is still “open for business” post-Brexit, and has suggested that it may cut corporation tax still further to maintain the United Kingdom’s attractiveness as a destination for inward investment.

For most groups, it makes little sense to restructure until the longer-term shape of the UK’s post-Brexit tax system becomes clear; for now, they should be aware of what might change as a result of Brexit, and what will probably not.

The Interest and Royalties and Parent-Subsidiary Directives

In general, income taxes are a matter for member states rather than the European Union, which can only legislate in the field of tax with the unanimous consent of all 28 member states. In the corporate tax field, the European Union’s most important interventions are the Interest and Royalties and the Parent-Subsidiary Directive, which eliminate withholding taxes between related parties that are resident in different member states.

The Interest and Royalties Directive removes withholding taxes on interest and royalties paid by a company in an EU member state to a company in another EU member state where one has a direct 25 percent shareholding in another, or a third EU company has a direct 25 percent shareholding in both. The Parent-Subsidiary Directive removes withholding taxes on dividends paid by a company in one EU member state to a company in another which has a 10 percent shareholding.

Leaving the European Union will mean that UK companies would cease to be entitled to benefit from the directives, unless the United Kingdom and the European Union agree to adhere to them as part of the terms of the United Kingdom's departure. In this regard, it is worth noting that Switzerland, which is not an EU member state, has adopted the directives in modified form in respect of payments between Swiss and EU companies.

If no such agreement is reached, however, UK companies making and receiving payments to and from related companies in other EU member states (or, indeed, Switzerland) will need to rely on tax treaties rather than the directives. While the United Kingdom has a good treaty network, a number of its treaties with other EU member states still permit some level of withholding on dividends, interest and/or royalties (in the case of the Italy treaty, it is all three). There will be no impact on dividends paid by UK companies, as the United Kingdom does not impose a dividend withholding tax, but there could be a significant impact on dividends paid to a UK holding company: in light of the fact that the United Kingdom now exempts the majority of such dividends from UK taxation, any withholding tax suffered in the country of origin would represent a real cost.

If the directives no longer apply post-Brexit, the attractiveness of the United Kingdom as a holding company jurisdiction may be impaired.

Cross-Border Mergers

The European Union has also introduced directives to enable cross-border mergers, divisions and share-for-share exchanges to take place on a tax-free basis. If these directives cease to apply in the United Kingdom as a result of Brexit, it would remove a number of restructuring options for groups with a presence in the United Kingdom. Indeed, as UK company law does not allow mergers at all, except to the extent required by EU directives, mergers involving UK companies may become impossible, meaning that groups would be forced to restructure themselves in other ways.

There are, however, relatively generous deferral and exemption reliefs in the UK tax code for intra-group transfers, reconstructions and share-for-share exchanges which do not derive from the directives; in many cases it will be possible for a group to take advantage of these. While the disapplication of the directive may make it more difficult for a group to restructure in a tax efficient manner, it should not generally render it impossible.

Base Erosion and Profit-Shifting (BEPS)

The United Kingdom has been an enthusiastic early adopter of BEPS-related measures proposed by the OECD, and Brexit is unlikely to change this. Shortly before the referendum, the European Union agreed on an anti-tax avoidance directive that contained a number of BEPS-related measures that member states are required to implement by January 1, 2019. While it seems likely that this directive will never come into force in the United Kingdom, all the measures within it were provisions that the United Kingdom already has in its tax code (such as controlled foreign company (CFC) rules) or has committed to introduce (such as limits on interest deductibility and anti-hybrid rules). The Finance Bill currently before Parliament implements a number of BEPS-related changes, and will not be affected by Brexit.

European Course of Justice (ECJ) Corporate Tax Precedents

Over the last 20 years, a number of groups have succeeded in arguing that various aspects of the UK corporation tax code contravene EU law and, in particular, the right of “freedom of establishment” in different member states that is enshrined in the European Union Treaty. In particular, the ECJ has held that the United Kingdom must allow group relief for losses of EU subsidiaries against the profits of their UK parents in limited circumstances, that the application of CFC rules to the profits of EU subsidiaries contravenes EU law unless the arrangement in question is “wholly artificial” and that the United Kingdom's former credit-based system for foreign dividends was potentially discriminatory, given that domestic dividends were exempt.

Once the United Kingdom leaves the European Union, it may no longer be bound by these decisions: although this will depend on the terms of its departure. If, for example, the United Kingdom decides to remain part of the European Economic Area (EEA), freedom of establishment will still apply, and the United Kingdom will still be bound by ECJ precedents based on it.

If, however, the United Kingdom leaves the EEA (so-called “hard Brexit”) these decisions will no longer be binding. Although unlikely, it is conceivable that the United Kingdom will legislate to reverse these decisions retrospectively. Companies with claims founded on these decisions therefore may wish to pursue them sooner rather than later.

A “hard Brexit” would also afford the United Kingdom greater freedom to legislate without regard to these decisions. It could, for example, strengthen its CFC rules or revert to a credit-based system for taxing foreign dividends. Given the stress that the Government has placed on remaining competitive, it seems highly unlikely that the United Kingdom would introduce measures that might reduce the attractiveness of the corporation tax regime, but it may seek to remove some of the complexities that have been introduced in order to comply with EU law. In particular, it would not be surprising if the requirement to apply transfer pricing to purely domestic transactions were abolished.

Value-Added Taxes (VAT)

EU member states are required to apply the common EU system of VAT. There is no chance of the United Kingdom abolishing VAT when it leaves the European Union (it raises too much money for that to be feasible); however, the UK system may diverge from the EU model over time.

One practical complication may arise for businesses that make supplies of internet-based services to consumers across the European Union, which are subject to VAT where the customer is located. Under the “Mini One Stop Shop” mechanism, introduced in 2015, such businesses can account for VAT on supplies to all member states to a single tax authority, which then redistributes the funds to the tax authorities of other member states as appropriate. When the United Kingdom leaves the European Union, it will probably become necessary for such businesses to be registered separately in the United Kingdom for supplies to the United Kingdom and in another member state for supplies to the remaining European Union member states.

Transfer Taxes

Decisions of the ECJ in recent years have effectively prevented the United Kingdom from enforcing a 1.5 percent stamp duty charge on the transfers of shares in UK companies into depositary receipts and clearance systems to enable them to be traded on foreign stock exchanges. As the United

Kingdom has no way of taxing transfers within those systems, this effectively allows shares in UK companies to be traded without any transfer tax, in contrast to trades on the London exchange, where a 0.5 percent stamp duty reserve tax charge applies. This charge may be reactivated once the United Kingdom leaves the European Union.

Customs Duties

Perhaps the most significant change may be the reimposition of customs duties and checks on the movement of goods between the United Kingdom and the remaining members of the European Union. Again, whether this will actually happen will depend on whether the United Kingdom opts for a “hard Brexit”; if it decides to join the EEA, nothing much should change.

Conclusion

Following the Brexit vote, there are all manner of things which could happen to the UK tax system, but as yet nothing much has. Any adverse changes that do eventuate from the United Kingdom leaving the European Union may well be outweighed by other changes initiated by the UK Government with a view to maintaining the United Kingdom's competitiveness.

Groups with existing investment in the United Kingdom will probably be best advised to hold fire before considering any restructuring, and to wait and see what Brexit means in practice. For groups considering establishing a UK holding company or headquarters operation, the potential loss of access to the Interest and Royalties and Parent-Subsidiary directives may be a significant consideration which means that the United Kingdom is less attractive than it would have been prior to the referendum. Nonetheless, in general, the UK corporate tax code remains a competitive one, so this should not necessarily be conclusive. Groups in either situation should keep a close eye on developments over the next few months.

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