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THE LONG ARM OF BREXIT

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Analysis

The long arm of Brexit

Speed read

The effect of Brexit on corporate groups will extend well beyond the sphere of customs duties and VAT. Groups will need to consider the potential effect of the loss of beneficial EU directives on the flows of dividends, interest and royalties. Provisions of domestic law in the UK and the rest of Europe which have been introduced to implement CJEU decisions – including provisions on group relationships, controlled foreign companies, reorganisations, mergers and share exchanges – may also be affected by Brexit, with implications for future transactions, current group structures and past periods too.

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The potential tax implications of Brexit are fast becoming leading topics of conversation amongst tax professionals. The issues troubling tax directors and their advisers have now progressed well beyond the significant effects of Brexit for customs duties and VAT into some of the more detailed implications for the operation of UK domestic law and the domestic tax laws of the remaining EU member states (the 'EU27').

On 13 July 2017, the government published the European Union (Withdrawal) Bill (the 'Withdrawal Bill') which has the stated intention of preserving EU law as it stands at the date of Britain's exit from the EU into UK legislation. However, without the agreement of the EU27, UK domestic legislation will not be sufficient to deal with the implications of Brexit under the domestic tax laws and treaties of the EU27.

This article sets out some examples of where this may lead to some unexpected results for international groups depending on how Brexit is ultimately implemented.

Withholding taxes and double tax treaties

Withholding taxes on UK: EU27 payments

We will start on familiar ground. As many others have commented, the direct application of EU directives to UK companies is one of the areas which will be instantly affected from the day the UK leaves the EU. This will apply equally to significant EU directives in the tax field such as Council Directive 2011/96/EU (the 'Parent-Subsidiary Directive') and Council Directive 2003/49/EC (the 'Interest and Royalties Directive').

Even if the Withdrawal Bill has the effect that the Parent-Subsidiary Directive and the Interest and Royalties Directive are given effect in the UK the day after Brexit, without some form of agreement with the EU27, UK companies in receipt of dividends, interest and royalties from companies established in the EU27 will no longer be able to rely on the provisions of those directives to eliminate withholding taxes that would otherwise be imposed on such payments under the domestic laws of EU27 states.

In those circumstances, UK companies will instead have to rely on the UK's double tax treaties with EU27 states to reduce or eliminate withholding taxes imposed by the domestic laws of EU27 states on such payments. The UK has a wide treaty network. But the relevant treaties will not always put a UK company in the same position as it would have been in under the directives.

The main concern here relates to dividends paid to UK parent companies by subsidiaries in EU27 states. There will be cases where the relevant double tax treaty will provide for a zero rate of withholding. The UK/France treaty is an example. In such cases, provided that the conditions for relief under the relevant treaty are met, there is at least the prospect of replicating the tax treatment that would have applied under the Parent-Subsidiary Directive.

In other cases, the relevant treaty may not operate to eliminate domestic withholding taxes. For example, under the UK/Germany tax treaty, payments of dividends by a German subsidiary to a UK parent company may be subject to a withholding tax of 5%. Given that most dividends received by UK companies are exempt from UK corporation tax, any withholding tax will be an additional cost of repatriating profits from German subsidiaries.

The inability of UK parent companies to obtain the benefits of the Parent-Subsidiary Directive may, therefore, have material consequences for some groups, particularly for UK parent companies with substantial operating subsidiaries in EU27 states (such as Germany) which have a treaty with the UK which does not entirely eliminate domestic withholding taxes. Such groups may have to consider whether or not it is possible to restructure in order to improve the flow of dividends through the group – although any restructuring options may be limited by the introduction of principal purpose tests into relevant double tax treaties as a result of OECD BEPS Action 6.

Withholding taxes on EU27: third country payments

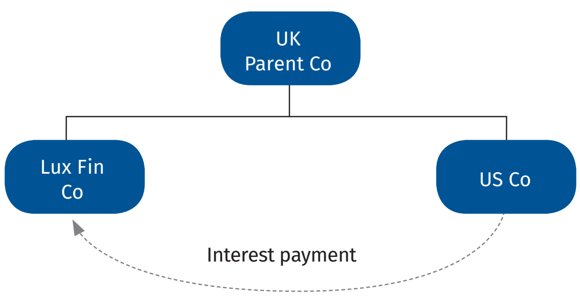
The presence of UK companies within corporate groups may also affect the ability of companies in EU27 states to claim the benefit of tax treaties with other third countries. The primary example of this effect is for EU27 companies that rely on double tax treaties with the US to reduce or eliminate withholding taxes on payments of dividends, interest and royalties where the relevant treaty contains a limitation on benefits (LOB) provision.

This is not the place to enter into a detailed review of LOB provisions in US treaties. However, it is worth noting that there are circumstances when the usual test of control by residents in contracting states will not be met and when corporate groups need to rely upon some of the other tests in the LOB provisions in order to benefit from the treaty in question. In such circumstances, the presence of a UK company in a group (or as a parent company of the group) may have an effect on the ability of an EU27 company to claim benefits under its treaty with the US.

LOB provisions in EU27/US treaties often permit a company to claim treaty benefits, in circumstances where the EU company in question would not necessarily be a 'qualified resident', by reference to tests which depend upon EU or EEA membership. Those other tests come in various forms but common requirements are:

- direct or indirect ownership of a proportion of the voting power or share capital in the company by persons who are resident in member states of the EU or the EEA (see, for example, articles 30(1)(c)(iii) and 30(4)(b) of the US/France treaty). Post-Brexit, EU27 companies which are relying on these provisions by reference to direct or indirect ownership by UK residents will no longer be entitled to treaty benefits; and
- in addition, and often supplemental to the ownership test outlined above, base erosion tests which specify a limit on the level of deductible payments that can be made to persons who are not resident in an EU member state (see, for example, articles 30(1)(d) and 30(4)(c) of the US/France treaty). In a similar vein to the point above, post-Brexit payments to UK companies will need to be taken into account by EU27 companies when considering such limits.

Here is a simple example highlighting the potential effect of the ownership provisions in practice. Under this example, a US company pays interest to a Luxembourg financing company. Both companies are subsidiaries of a UK parent company which is owned by UK resident individuals and is not listed.



The payment of interest attracts US withholding tax at 30%. However, the withholding is reduced to 0% if the Luxembourg company can claim the benefit of the US/Luxembourg double tax treaty. In order to claim the benefit of the treaty, the Luxembourg company will need to satisfy the requirements of the LOB provision which is found in article 24 of the US/Luxembourg treaty.

If we assume for present purposes that the Luxembourg company does not qualify under any of the other tests in the LOB – so, for example, the Luxembourg company does not carry on an active trade or business within article 24(3) – it may be necessary for the Luxembourg company to rely upon the provisions of article 24(4) of the treaty (the equivalent beneficiaries provision) in order to obtain treaty benefits. Inter alia, article 24(4) requires that 95% of the company's shares are ultimately owned by seven or fewer residents of a state that is a party to NAFTA or that is a member state of the EU, with which the US has a comprehensive income tax treaty (which provides a rate of tax equal to or less than the rate under the US/Luxembourg treaty for that item of income).

In the example above, this requirement of the LOB is satisfied: the UK parent company owns 100% of the Luxembourg company's shares, the UK is a member of the EU and the UK/US treaty also provides for a 0% rate of withholding on interest. Post-Brexit, this test will not be met simply because the UK is no longer a member of the EU and the payment of interest will attract US withholding tax.

Group relationships

The tax implications of Brexit will go well beyond withholding taxes, the potential loss of beneficial EU directives and the application of double tax treaties. There are also many provisions of domestic law in the UK and the rest of Europe which have been introduced to implement decisions from the Court of Justice of the European Union (CJEU) giving effect to the fundamental freedoms under the EU Treaty. These provisions may also be affected by Brexit.

One such area is how the domestic law of EU member states has defined group relationships for the purposes of provisions of domestic laws which permit tax-neutral transfers of assets and arrangements for the use of tax losses within corporate groups.

> Following Brexit, the presence of UK companies in corporate groups involving EU27 companies may break existing group relationships and fiscal consolidations preventing relevant reliefs being available in the future and, in some cases, resulting in the clawback of reliefs obtained in past periods

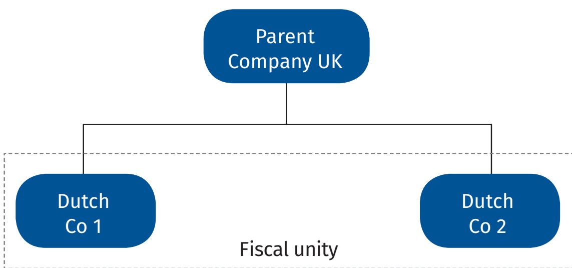
The starting point was probably the CJEU decision in *ICI plc v Colmer* (Case C-264/96). The case itself concerned a relatively narrow question of whether a particular provision of UK tax law governing the conditions for certain consortium relief claims infringed the freedom of establishment of companies under the EU Treaty. However, the implications of the decision were much wider. In response, as well as implementing the changes to give effect to the CJEU decision, the UK made changes to other grouping definitions. So, for example, in Finance Act 2000, the UK changed its definition of groups for the purpose of corporation tax on chargeable gains so that the principal company of the group could be a non-UK company and that group relationships could be traced through non-UK companies. Those definitions operated on a worldwide basis; the benefit of the changes was not limited to companies established in EU member states.

This is not always the case in other EU jurisdictions. For example, in Ireland, the grouping definition for the purposes of Irish corporation tax on chargeable gains applies so that only companies which are EU resident can be members of the same group. This means that UK companies that are currently treated as members of groups for Irish tax purposes will cease to be members of those groups at the time of Brexit. Furthermore, without some form of agreement, or a unilateral concession or change of law in Ireland, clawbacks of relief granted pre-Brexit could occur. For example, if relief was claimed on the intra-group transfer of assets by an Irish resident company to an Irish branch of a UK resident company at any time within the period of ten years before the day of Brexit, the relief may be clawed back from the Irish branch.

With the exception of the specific provisions relating to the cross-border surrender of losses by EU companies (introduced to implement the CJEU decision in *Marks & Spencer v Halsey* (Case C-446/03)), the definitions of group for group relief purposes operate in a similar (non-EU centric) way. The same is not, however, the case in other EU member states, where group definitions and tax consolidations are often limited by reference to companies established in EU member states. The result is that, following Brexit, the presence of UK companies in corporate groups involving EU27 companies may break existing group relationships and fiscal consolidations preventing relevant reliefs being available in the future and, in some cases, resulting in the clawback of reliefs obtained in past periods.

> The task of identifying the consequences and dealing with them is herculean – for both tax professionals and tax authorities alike

By way of example, Dutch entities can only form a fiscal unity (essentially a tax consolidation) with other Dutch entities which are members of the same group. This relationship can be traced through EU and EEA companies. So, for example, Dutch sister companies can form a fiscal unity where they are linked by an EU or EEA parent company. This principle does not apply where the parent is not established in the EU or EEA.



Therefore, in the structure above, the current position is that Dutch Co 1 and Dutch Co 2 can form a fiscal unity, which enables losses made in one entity to be set against taxable profits of the other and removes tax liabilities arising on intra-group transactions. Post-Brexit, and assuming that the UK does not remain in the EEA, Dutch Co 1 and Dutch Co 2 will no longer form a fiscal unity. This will prevent the companies from obtaining the benefits of fiscal consolidation in the future, but will also result in the clawback of reliefs on any transfers of assets which have taken place between the two Dutch Cos in the previous six years.

Controlled foreign companies

Another area in which EU law has affected the development of domestic law systems is in the application of controlled foreign company (CFC) rules. In *Cadbury-Schweppes plc v Inland Revenue Commissioners* (Case C-196/04), the CJEU held that CFC rules applied by one EU member state to impose tax on a company resident in that state by reference to the profits of its EU subsidiaries might infringe EU freedom of establishment principles unless their imposition could be justified to prevent wholly artificial arrangements which did not reflect economic reality.

The current UK CFC rules do not generally rely on specific exclusions for EU based companies in order to meet the requirements of the CJEU decision. Once again, this approach has not been adopted across the EU.

For example, Spain considers a non-resident company to be a CFC where tax paid on its profits in its jurisdiction of residence is lower than 75% of the tax that would had been paid if the company had been subject to Spanish corporate income tax. There is, however, an exception for EU resident companies that can demonstrate valid economic reasons for their establishment in the relevant jurisdiction and which carry on active business activities there.

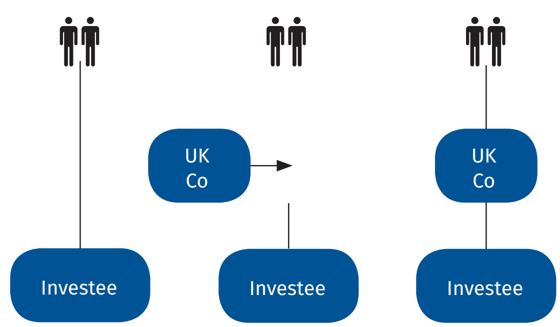
Post-Brexit, UK companies which are subsidiaries of Spanish companies will potentially fall within the Spanish CFC rules. If the UK reduces its corporation tax rate to 17% from April 2020 as currently proposed (a rate which is less than 75% of the current headline Spanish rate of 25%), there will be an increased risk of charges to tax under Spanish CFC rules.

Reorganisations, mergers and share exchanges

The UK has implemented other EU directives and regulations in a manner which limits the benefits to EU resident companies. So, for example, the specific reliefs for the incorporation of EU permanent establishments or cross-border mergers (contained in Council Directive 2009/133/EC (the 'Mergers Directive')) extend only to EU based companies and businesses. The Withdrawal Bill may preserve the UK tax treatment of these transactions, but, as before, any reciprocity in EU27 states will be dependent on some form of agreement with or unilateral action on behalf of EU27 states.

The UK did not have to make changes to UK law to give effect to those parts of the Mergers Directive that dealt with the share for share exchanges. Those provisions have always operated without reference to the place of incorporation or tax residence of the companies involved. But again, that is not always the case in EU27 states. Some only permit share for share exchanges to receive a tax deferral where the relevant companies are based in the EU. Such transactions will be affected by Brexit and there is a risk that prior transactions may be revisited under applicable domestic laws.

By way of example, if German resident shareholders in a German company exchange their shares for shares in a UK company, the exchange is exempt from German capital gains tax. However, if Brexit occurs within seven years of the exchange, the capital gains tax relief under these provisions will be clawed back by imposing a capital gains tax liability on the shareholders.



Final thoughts

This article could only ever scratch the surface of the potential tax implications of the UK leaving the EU. There are numerous other examples. The task of identifying the consequences and dealing with them is herculean – for both tax professionals and tax authorities alike. ■

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