MACFARLANES

LIFE AFTER BREXIT FOR CORPORATE TAXPAYERS

The UK Prime Minister, Theresa May, has formally given notice under Article 50 of the EU Treaty of the UK's intention to leave the EU. That notice begins the two year period during which the UK will negotiate the terms of its exit from the EU with the other 27 EU member states (the "**EU27**").

This note sets out some of the key tax issues that corporate taxpayers will face in March 2019 in the absence of a specific agreement with the EU27 and in the absence of any agreement on an extension to the two year period.

CUSTOMS DUTIES

As part of the EU customs union, goods can be transferred from the UK to the EU27 and from the EU27 to the UK without the imposition of customs duties. Duties on imports and exports from non-EU states are governed by the EU customs code and agreements reached by the EU with non-EU states.

In the absence of specific agreement, when the UK leaves the EU:

- the UK will cease to be part of the EU customs union;
- UK legislation will be needed to replace the EU customs code and, subject to any relevant trade agreements (if any), will govern the duties levied on imports to the UK;
- UK exports to the EU27 will attract customs duties on WTO terms; and
- UK exports to non-EU member states will attract customs duties in those states at rates governed by local law or, if applicable, WTO rates or specific rates under trade agreements between the UK and those states.

VALUE ADDED TAX

UK VAT legislation is derived from EU law, in particular, the Principal VAT Directive. EU law ensures a degree of harmonisation and consistency of the VAT system across the EU.

When the UK leaves the EU:

- although it is difficult to believe that the UK will not retain a VAT system given its importance to UK tax revenues, the UK will not be under any obligation to maintain the common EU system of VAT;
- UK courts will no longer be required to follow the Court of Justice of the European Union (the "**CJEU**") decisions on VAT, although we would expect CJEU decisions to remain at the very least persuasive authority in UK courts and tribunals;
- even if the VAT system retained by the UK broadly follows the EU system (at least initially), supplies made by and to UK companies by and to suppliers and customers in the EU27 will no longer be intra-EU supplies:
  - UK importers will have to pay import VAT (rather than to simply declare VAT through their VAT returns) when goods are supplied to them form the EU27 and, even if it is recoverable, the import VAT will be a cash-flow cost; and
  - EU27 customers will incur import VAT on goods supplied by UK exporters (and, even if the import VAT is ultimately recoverable suffer a similar cash-flow cost).

Although when the UK leaves the EU, it is extremely likely that VAT will be retained, the fact that the UK will no longer be required to comply with EU VAT law gives rise to the possibility that over time UK and EU VAT law will diverge.

For example:

- There will be no pressure on the UK to remove existing zero rates of VAT (such as on food and children's clothing).
- It is likely that the UK will continue to take some approaches to the interpretation of VAT law that might appear to be at odds with CJEU jurisprudence: for example, treating certain "back office" services which are supplied to insurers (such as claims-handling) as exempt from VAT and not accounting for VAT intra company supplies from a non-UK branch or head office to a UK establishment of the same company.
- In the future, there is the possibility that existing zero or preferential rates will be expanded either for political expediency (remember pasty tax!) or deliberately to incentivise particular sectors.

WITHHOLDING TAXES

UK companies currently benefit from various EU directives under which dividends, interest and royalties can be paid free of domestic withholding taxes provided that relevant conditions are met.

In particular:

- the Parent Subsidiary Directive[1] requires that dividends paid by a company resident in an EU member state to a company resident in another EU member state which holds a 10%+ stake in the paying company must be made

[1] EU Council Directive 2011/96/EU

free of withholding tax in the state of residence of the paying company, and be either exempt from tax or subject to tax with credit for the withholding tax and underlying tax in the state of residence of the recipient company; and

- the Interest and Royalties Directive[2] requires payments of interest and royalties made by a company resident in an EU member state to a company resident in another EU member state to be exempt from withholding taxes where the two companies are associated.

When the UK leaves the EU, UK companies will no longer be able to rely on the Parent Subsidiary Directive and the Interest and Royalties Directive to reduce withholding taxes on payment or receipt of dividends, interest or royalties from companies established in the EU27.

The most important of these is the Parent Subsidiary Directive. The UK does not impose a withholding tax on dividends paid by UK resident companies. However, the Parent Subsidiary Directive does allow UK companies to receive dividends from companies in EU27 states free of withholding taxes. It has been an important element in UK companies becoming attractive European holding companies for multinational groups.

The UK has an extensive network of double tax agreements, which will continue to apply to reduce or eliminate withholding taxes on cross-border payments following Brexit. The UK has a double tax treaty with each of the EU 27. However,

- although some UK treaties with EU27 countries will apply to eliminate withholding taxes, most will permit withholding albeit at a reduced level compared with the domestic rate;

- some UK treaties with EU27 countries impose more onerous requirements than the Parent Subsidiary Directive on the availability of exemption from or reduced rates of withholding taxes under the treaty; and

- in particular some UK treaties with EU27 countries require that dividends received by a UK company must be "subject to tax" in the UK in order for exemption or reduced rate of withholding to apply.

  On this final point, most dividends received by UK companies will normally be exempt from UK corporation tax legislation (and so a treaty that requires a recipient of a dividend to be "subject to tax" in order to qualify for a reduced rate of withholding will not apply). However, UK legislation allows UK companies to elect not to benefit from the exemption from corporation tax for dividends received. It may prove beneficial for UK companies to elect to pay tax on dividends received from companies established in some EU27 states (in particular Portugal) in order to benefit from treaty rates of withholding.

The appendix to this note sets out a summary of the rates of withholding tax on dividends paid by companies resident in the EU27 states under applicable tax treaties with the UK.

OTHER EU DIRECTIVES AND REGULATIONS

UK companies are subject to a host of other EU directives and Regulations which govern their tax affairs. Some of these - such as the Mergers Directive[3] - provide reliefs from taxation in cross border transactions, others - such as the Anti-Tax Avoidance Directive[4] ("ATAD") - set out minimum standards for anti-avoidance legislation.

In the absence of agreement with the EU27, when the UK leaves the EU:

- UK companies will no longer be able to rely on directives (such as the Mergers Directive) which govern the treatment of cross-border transactions with EU27 companies; and

- the UK will not be subject to the requirements of directives and regulations that impose minimum requirements on UK legislation.

There is a risk that cross-border transactions that benefit from some of these directives and regulations will cease to be capable of being implemented or cease to be tax-effective on Brexit in the absence of an agreement between the UK and EU27. Cross-border mergers and migrations of European companies fall into this category. Groups which may wish to take advantage of these measures (particularly for group reorganizations) would be well-advised to accelerate their plans.

As regards measures, such as ATAD, which impose minimum standards for avoidance legislation, although the UK will no longer be required to ensure that domestic legislation meets these requirements, it seems unlikely, given the current direction of travel in UK tax policy, that the UK will immediately take the opportunity to repeal its domestic legislation. For example, the UK has been at the forefront of the implementation of measures that fall within the OECD / G20 BEPS Project. As a result, UK legislation for the most part already includes

[2] EU Council Directive 03/49

[3] EU Council Directive 2009/133/EU

[4] EU Council Directive 2016/1164/EU

measures that go far beyond the requirements of ATAD and they will be in force a long time before the ATAD deadline. There seems little prospect of any material relaxation of these domestic law provisions.

EU TREATY FREEDOMS

The fundamental freedoms enshrined in the EU Treaty - freedom of establishment, freedom of movement of capital, freedom of movement of workers and freedom of movement of goods - have significantly influenced the development of UK tax legislation. Some of these changes were made following high-profile court cases - for example, changes to the group relief rules and controlled foreign companies rules following the Marks & Spencer[5] and Cadbury Schweppes[6] cases – others where EU Treaty freedoms have been taken into account in UK tax reform.

When the UK leaves the EU:

- In principle, the UK will be free to construct its tax legislation in a manner which is not constrained by the fundamental freedoms. However, we will have to wait and see the extent to which the UK chooses to take advantage of this new found freedom.
- The most obvious manifestation will be that the UK will be able to restrict availability of tax reliefs to UK resident taxpayers and groups involving only UK resident companies.
- One specific effect is related to the UK legislation which imposes a higher rate SDRT charge on certain issues of shares by UK companies to depositary receipt issuers and clearance services. This legislation remains on the statute book but the charge has not been enforced by HMRC after the charge was ruled[7] to be contrary to the EU rules on freedom of movement of capital. After Brexit, the UK would be free to enforce that charge once again.

---

[5] Case C-446/03
[6] Case C-196/04
[7] *HSBC and Vidacos v HMRC* [2010] STC 58

CONTACT DETAILS
If you would like further information or specific advice please contact:

ASHLEY GREENBANK
PARTNER
TAX
DD +44 (0)20 7849 2512
ashley.greenbank@macfarlanes.com

MARCH 2017

APPENDIX

DIVIDENDS PAID TO UK BY COMPANIES IN EU27: EFFECT OF DOUBLE TAX TREATIES

When Britain leaves the EU and the Parent-Subsidiary Directive no longer applies, the rate of withholding tax due on dividends paid by a company in an EU27 state to a holding company in the UK will be governed by the bilateral treaty between the individual state and the UK. The table below shows those different rates.[1]

	Withholding rates under applicable UK treaty:				**Domestic withholding rate[2]:**
	Qualifying company withholding tax rate:	**Capital/voting power conditions for qualifying company rate:**	**Other conditions for qualifying company rate:**	**Withholding rate if qualifying company conditions not met:**	
Austria	5%	Direct or indirect control of 25% of voting power	n/a	15%	25%
Belgium	0%	Direct holding of 10% of capital	10% capital holding uninterrupted for 1 year	10%	30%
Bulgaria	0%	n/a	n/a	n/a	5%
Croatia	5%	Direct or indirect control of 25% of capital	n/a	10%	12%
Cyprus	0%	n/a	n/a	0%	0%
Czech Republic	5%	Control of 25% of voting power	n/a	15%	15%
Denmark	0%	Direct holding of 25% issued share capital	n/a	15%	27%[3]
Estonia	5%	Direct control of 25% of voting power	n/a	15%	A distribution tax at a rate of 20/80 of the net amount of the profit distribution, corresponding to 20% on the gross amount. There is no additional WHT

[1] The rates given are based on the presumption that the UK does not remain a member of the EEA
[2] If treaty not available
[3] Reduced to 22% through a refund procedure

Finland	0%	n/a	If not acquired for bona fide commercial purposes the beneficial owner must be subject to tax in the UK on the dividends if it holds 10%+ of the shares and the dividends are paid out of profits earned more than 12 months before the beneficial owner acquired the 10%.	n/a	20%
France	0%	Direct or indirect holding of 10% of capital	Beneficial owner must be a company liable to corporation tax	15%	30%
Germany	5%	Direct holding of 10% of capital	Beneficial owner must be a company (other than a partnership)	15%	25%[4]
Greece	-[5]	n/a	n/a	n/a	15%
Hungary	0%	Direct or indirect control of 10% of voting power	n/a	10%	0%
Ireland	5%	Direct or indirect control of 10% of voting power	n/a	15%	0%[6]
Italy	5%	Direct or indirect control of 10% of voting power	n/a	15%	26%
Latvia	5%	Direct control of 25% of voting power	n/a	15%	15%
Lithuania	5%	Direct control of 25% of voting power	n/a	15%	15%
Luxembourg	5%	Direct or indirect control of 25% of voting power	n/a	15%	15%[8]
Malta	0%	n/a	n/a	0%	0%
Netherlands	0%	Direct or indirect control of 10% of voting power	n/a	10%	15%
Poland	0%	Holds 10% of capital	10% capital holding uninterrupted for 2 years	10%	19%
Portugal[7]	10%	Direct control of 25% of voting power	Dividends subject to tax in the UK	15%	25%
Romania	10%	Direct or indirect control of 25% of voting power	n/a	15%	5%
Slovak Republic	5%	Control of 25% of voting power	n/a	15%	35%[9]

[4] 26.375% including the 5.5% solidarity surcharge
[5] No rate specified in the treaty
[6] However an appropriate declaration under Schedule 2A TCA 1997 will have to be made otherwise the rate is 20%
[7] The UK/Portugal Treaty requires dividends paid to a UK company to be subject to tax in the UK for the treaty to apply to reduce Portuguese withholding taxes. So the treaty rates will not be available unless a UK recipient company elects not to benefit from exemption from corporation tax under s931R CTA 2009. As such it will be necessary to decide whether to elect into UK tax or not.
[8] With an exemption if the parent is a fully taxable corporation and owns directly or indirectly at least 10% capital, or a participation with an acquisition cost of at least €1.2m, for an uninterrupted period of at least 12 months
[9] Provided it is derived from profits generated as from 1st Jan 2017 (0% if from profits generated 1st Jan 2004 - 31st Dec 2016)

Slovenia	0%	Directly holds of 20% of capital	n/a	15%	15%
Spain	0%	Direct or indirect control of 10% of capital	n/a	10%	19%
Sweden	0%	Direct or indirect control of 10% of voting power	n/a	5%	30%[10]

[10] Unless paid on business-related (organisational) shares in which case they are exempt