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The tax impact of Brexit: what steps should UK and EU businesses take now?

On 23 June 2016 the UK voted to leave the European Union. Whilst many of the terms of exit are hard to anticipate, there are a number of predictable adverse effects for which preparations can be made. This briefing outlines some mitigating steps that UK and EU businesses can take now.

What happens now?

It is expected that HM Government will issue a notice under Article 50 of the Treaty on European Union (**TEU**). This will trigger a negotiation over the terms of the UK's exit, which will be contained in a withdrawal agreement.

The UK will actually leave the EU on the earliest of the date the withdrawal agreement comes into effect, and the date falling two years after the Article 50 notice is served (although the European Council can unanimously vote to extend the period).

Neither the referendum vote nor the Article 50 notice will have any tax effect. However exit itself will have a large number of immediate effects. Many of those will be highly dependent on the precise terms of the UK's exit, and are therefore hard to predict.

This briefing summarises those effects which are in our view relatively clear, where there is real potential for businesses to be adversely affected, and where there is action that could be taken now by affected groups.

There will be many other consequences of exit. In particular, numerous technical changes will have to be made to UK tax legislation where there is currently an interrelationship with EU law, or where the application of the law currently depends on whether a person is resident in the EU. In the case of VAT these issues are fundamental to how the tax works. These complexities may have adverse effects on particular businesses, but given the multiple uncertainties involved at this stage, they are not discussed further in this briefing.

Impact on UK headquartered groups

The most significant immediate consequences for UK headquartered groups are likely to result from UK companies losing the benefit of the Parent-Subsidiary Directive and the Interest and Royalties Directive.

At present, the effect of these Directives is that a UK parent company receiving interest, royalties or dividends from wholly owned subsidiaries elsewhere in the EU will generally receive those payments free from withholding tax. When the UK leaves the EU that will no longer be the case.

Double tax treaties will reduce the withholding rates in some cases, but in the following cases the withholding will not be eliminated:

Dividends paid by subsidiaries resident in Austria, the Czech Republic, Estonia, Germany, Greece, Italy, Latvia, Lithuania, Malta, Portugal, Romania and Slovakia – and in certain circumstances Luxembourg.

Interest and royalties paid by subsidiaries resident in Italy and Portugal.

It is possible, but we think unlikely, that the benefit of the two Directives could be duplicated in the terms of a withdrawal agreement, a subsequent agreement between the UK and the EU, or amendments to the UK's double tax treaties with the affected jurisdictions.

Businesses may therefore wish to start identifying the extent to which their existing group structure will be subject to these withholding taxes, and then give consideration as to whether those taxes can be mitigated.

In the past it might have been thought this could be achieved by as simple a step as inserting, for example, an Irish holding company between a UK parent and an EU group. However, in light of modern views of beneficial ownership, the ongoing implementation of the OECD BEPS Project and the anti-avoidance rule written into the Parent-Subsidiary Directive last year,

a restructuring of that kind may not be effective.

UK headquartered groups with significant European subsidiaries, and which expect to be materially hit by withholding taxes on intra-group dividends, may need to consider taking radical measures. It may be that the only way to maintain the benefits of being an EU headquartered group would be to shift the parent company and headquarters from the UK to another EU Member State. That could be achieved, for example, by "inverting" the group so that it becomes headquartered in (say) Ireland, with shareholders owning the new Irish parent, and the UK and EU subsidiaries held directly by the Irish parent. A plan of this kind would need careful consideration because it might for example have adverse US tax consequences if there are US tax subsidiaries or if a future US merger is planned.

Impact on EU groups with material UK subsidiaries

EU headquartered groups with UK subsidiaries will have similar issues.

The UK does not charge withholding tax on dividends and that does not depend on EU membership.

But the effect of the Parent-Subsidiary Directive is that a dividend paid by a UK wholly owned subsidiary to a parent elsewhere in the EU will generally not be subject to tax in the parent's jurisdiction. When the UK leaves the EU the Directive will no longer apply. Some jurisdictions (e.g. The Netherlands and Luxembourg) have generous participation exemptions that apply even to non-EU subsidiaries. Others do not, and so the EU parent would be subject to non-UK tax on its dividends from UK subsidiaries. Credit will in many cases be available, but given the low rate of corporate tax in the UK, the credit will likely only reduce the tax, not eliminate it.

There may also be impacts for taxes on capital gains and controlled foreign company rules where domestic exemptions and reliefs in other EU states currently depend on the UK's status as an EU member.

EU headquartered businesses may wish to start identifying the extent to which the loss of the Directive or other EU benefits will be a material cost. In extreme cases, a business might consider moving its headquarters to, for example, The Netherlands or Luxembourg.

Impact on cross-border mergers

The company law in many EU jurisdictions includes the concept of merger by universal succession, whereby the rights and obligations of one company become inherited by another company by process of law.

There is no such concept in domestic UK company law, and a "merger" is therefore typically accomplished by one company acquiring another (or acquiring its business).

Similarly, many EU jurisdictions' company law facilitates the division of a company into two or more successors; UK company law does not.

However the Cross-Border Mergers Directive enables mergers and divisions to be effected within the EU, including the UK, and the related Mergers Directive means that such mergers and divisions are (very broadly) tax neutral from a direct tax perspective.

These Directives would cease to apply to mergers and divisions from/to the UK following the UK's exit from the EU. Accordingly any group contemplating such a merger or division may wish to put such plans into effect as soon as possible.

Impact on issuance of depositary receipts, etc.

UK stamp duty reserve tax has historically been charged at 1.5% on the issue of shares into depositiary receipt/clearance systems (including, but not limited to, American Depositary Receipt systems).

In the *HSBC Holdings* case in 2012, this charge was found to be contrary to EU law (the Capital Duties Directive). Since then, HMRC has not applied the 1.5% charge, but UK statute has not been amended. Accordingly, upon the UK leaving the EU, it seems to us likely that the 1.5% charge will again apply on depositary receipt issuances.

Any business planning a depositary receipt issuance may therefore wish to do so within the next two years.

Loss of other EU rights

There are other areas of UK tax law where EU law challenges have resulted in benefits for taxpayers and/or limitations in HMRC's taxing power. For example, historically a UK group company could surrender tax losses to other UK group members, but a non-UK member of the group could not. Following the *Marks & Spencer* and *Philips Electronics* cases, foreign losses can be utilised in certain limited cases.

It seems to us quite likely that this benefit would be lost upon the UK leaving the EU. Groups with profitable UK companies, but loss-making EU subsidiaries, may wish to consider if they can utilise those losses within the next two years. Groups headquartered in other EU states which have loss-making UK subsidiaries should consider this issue in reverse.

Further information

If you would like further details on any of the issues discussed in this briefing, or how it applies to your business, please speak to your usual Clifford Chance contact or any of those listed below.

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