Comment

# Brexit: tax implications for multinationals


## Speed read

**On 23 June 2016, the UK voted to leave the EU. No immediate emergency Budget is expected but the Autumn Statement may provide an indication of future tax policy. Whilst the terms of the UK's future relationship with the EU remain hard to predict, some tax consequences of the UK's withdrawal from the EU can be anticipated. Tax directors should review their existing corporate structures, and any new investment structures, for possible post-Brexit tax inefficiencies. Mitigating action may be possible. Looking further ahead, the UK may have more flexibility in setting UK tax policy, whether to attract investment or otherwise, although radical changes seem unlikely.**



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On 23 June 2016, the people of the UK voted to leave the EU. The process of working out what that means will now begin, both in terms of what the UK's future relationship with the EU and the rest of the world will look like, and what it means for the UK business landscape and the activities of multinationals in and with the UK.

From a tax perspective, there are perhaps three main phases to consider: the immediate reaction of the UK government; the anticipated consequences of the UK ceasing to be a member of the EU; and the longer term implications for UK tax policy.

## Immediate implications

Technically, nothing has changed as a result of the referendum. EU law continues to apply in the UK as it did before, including as regards tax matters, and it will continue to do so until the UK formally exits the EU. The complexity of the withdrawal process means that this is highly unlikely to occur before 31 December 2018 – and may be later.

However, in the face of the immediate uncertainty, the UK government has some near term fiscal policy decisions to make. George Osborne has already confirmed that taxes will need to rise, but businesses will also need to be reassured that the UK remains an attractive place to do business. The prospect of an immediate emergency budget seems to have faded (aside from the unexpected acceleration of the extended royalties withholding tax!), and detailed announcements are likely to be postponed until the Autumn Statement.

It will be interesting to see whether the implementation of major tax reforms, such as the proposed 'interest barrier' and changes to the corporate loss rules, are delayed in light of the need to preserve stability and to focus Treasury resources on negotiating the UK exit.

It will also be interesting to see how the UK courts react to the referendum vote. Will they be more reluctant to refer a question to the CJEU, if it is unclear whether any answer will be obtained pre-Brexit and whether it will be binding?

## Looking towards Brexit

It is of course difficult to predict what the future will hold. Assuming the UK does in fact leave the EU, the resulting tax implications will depend on the precise terms of the withdrawal arrangements and the new relationship with the EU going forward. However, there are some known consequences, some likely consequences and some possible consequences that can be anticipated.

## The known knowns: EU tax directives

Upon leaving the EU, unless agreed otherwise in the withdrawal agreement, the UK will cease to benefit from (or be bound by) the various European tax directives, including the Interest and Royalties Directive (IRD), the Parent-Subsidiary Directive (PSD), the Cross-Border Mergers Directive and the Capital Duties Directive.

### PSD and IRD

The PSD and IRD provide exemptions from withholding tax on dividends, interest and royalties between related parties in the EU. The PSD also provides exemption from tax on receipt of dividends from an EU subsidiary.

The withdrawal of the PSD from UK companies will be mitigated somewhat by the UK's extensive treaty network. However, full protection cannot be assumed. Some 12 out of the 27 member states currently impose withholding tax on dividends, which would not be reduced to nil under a UK double tax treaty. For example, post-Brexit dividends paid by a German subsidiary to its UK parent would suffer withholding tax at 5% versus the nil rate currently mandated by the PSD.

Similarly, inbound dividends received by EU parents from UK subsidiaries may become subject to tax in jurisdictions, such as Ireland, where tax treatment varies as between EU and non-EU source dividends.

The IRD is perhaps less significant in practice, given its narrow scope. However, the extension of the UK royalties withholding tax regime may render it more relevant for groups with UK operations. Also, groups that have activities in Gibraltar, such as the gaming sector, may be disproportionately affected given Gibraltar's lack of double tax treaties.

Tax directors should review their existing corporate structures – and any new acquisition or investment structures – for possible tax inefficiencies resulting from the loss of the benefit of the PSD and IRD. Reorganising corporate structures to benefit from more favourable tax treaties may be desirable; however, they will need to be reviewed against the backdrop of the OECD BEPS work in relation to treaty abuse, recent developments in relation to the 'beneficial ownership' requirement and applicable anti-avoidance rules.

### Capital Duties Directive

Brexit could also affect the (non-)application of the 1.5% SDRT charge on share issues into clearing and depositary receipt systems. Technically, this remains on the statute book but it is not enforced by HMRC in light of *HSBC Holdings* [2012] UKFTT 163. The UK's exit from the EU and consequent lapse of the Capital Duties Directive in the UK would open the possibility of the charge being reinstated (subject to free movement of capital arguments). However, it is to be hoped that the UK government would not pursue such an approach.

### Other Directives

Following the UK's formal withdrawal from the EU, the EU directives on administrative cooperation and mutual assistance will no longer apply in the UK, including the forthcoming automatic exchange of tax rulings. Overall, however, the impact is likely to be limited, given the broadly similar rights and obligations under the OECD multilateral convention.

Other proposed EU initiatives would also cease to apply upon Brexit, such as public country by country reporting under the Accounting Directive and the Anti-Tax Avoidance Directive. The latter is proposed to come into effect from 1 January 2019 and accordingly may post-date the UK's exit in any event.

## The known knowns: VAT and the customs union

Leaving the EU will have significant compliance implications for VAT and customs duties, as supplies that are currently intra-EU become exports and imports. Reporting and cash flow management will need to be reassessed (including having regard to the less streamlined 13th Directive refund process); and existing cross-border supply chains could become unwieldy and inefficient.

Furthermore, depending on the UK's future relationship with the EU, intra-group transfers of goods and services between entities in the UK and the EU may become subject to absolute costs in the form of import/export duties and/or non-tariff trade barriers. This may also extend to transactions between UK and non-EU operations, as the UK ceases to benefit from free trade agreements (FTAs) in place between the EU and third countries.

In some cases, the additional compliance costs and/or tariffs may lead to internal reorganisations and a relocation of activities may become desirable.

## The known unknowns: EU fundamental freedoms

As a member of the EU, the UK is subject to the four fundamental freedoms. Members of the EEA are similarly bound.

If the UK ceases to be in the EU and does not join the EEA, then the UK may seek to reinstate domestic rules that have previously been found to be in breach of the fundamental freedoms. For example, the ability to surrender losses to and from non-UK group members following *Marks & Spencer* (Case C-446/03) and *Philips Electronics* (Case C-18/11) may be an obvious target for repeal.

However, it could also work the other way. The loss of EU status for UK resident companies could have adverse implications under the laws of other member states, many of which have developed tax rules that take account of the EU fundamental freedoms in their application to EU resident companies.

For example, France recently amended its fiscal consolidation rules to permit consolidations through EU resident entities, as well as French entities. Groups that rely on consolidating through UK entities may be forced to restructure post-Brexit.

Similarly, in a number of jurisdictions, such as Germany and Spain, CFC rules operate by reference to the high *Cadbury* threshold of wholly artificial arrangements (Case C-196/04) as regards EU resident subsidiaries, but adopt a lower threshold for non-EU subsidiaries. This could lead to the profits of UK subsidiaries becoming subject to taxation under overseas CFC rules.

Again, however, much depends on what is ultimately negotiated with the EU. In particular, accession to the EEA would in effect involve the continuation of the fundamental freedoms (since they are broadly the same in the EEA Agreement as in the EU Treaties); and therefore the prohibition on discrimination as between UK and EU resident companies would continue.

## Tax policy making

Looking further ahead, in theory the UK's exit from the EU will allow greater flexibility in setting UK tax policy.

The most obvious example is VAT, where the UK government would be free to amend, extend or repeal VAT laws as it sees fit. In reality, whilst the EU and UK VAT systems would be likely to diverge over time, the expectation is that wholesale changes are unlikely, not least given the global trend towards VAT systems rather than sales tax or GST.

There would also be scope for the UK to introduce additional consumption based taxes (which are currently prohibited by the EU Treaty). These may be politically attractive in light of the continuing furore over the tax treatment of multinationals selling into the UK.

In a similar vein, the UK may find itself freed from EU rules governing state aid and harmful tax practices. This could allow the UK to introduce tax policies designed to attract investment into particular sectors, including investment allowances. However, again it will depend on the model adopted; EEA membership, for example, would carry obligations similar to the EU's state aid rules. And, as regards harmful tax practices, the UK's commitment to the OECD developments in this area would presumably continue outside the EU.

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The Leave campaign has also made comments about the possibility, post-Brexit, of legislating to prevent the payment of compensation in respect of EU infringement claims, such as those at issue in *Littlewoods* [2015] EWCA Civ 515. The amounts at stake may make this an attractive proposition for any UK government, and is unlikely to be unpopular amongst the general electorate. In the same publication, the Leave campaign also mooted the possibility of reintroducing the CFC regime as it was in force prior to the *Cadbury* decision, although this seems unlikely – at least under the current government.

## Final remarks

The immediate impact of the referendum vote for tax directors and professionals is limited. Much will depend on the nature of the UK's future relationship with the EU, which will take shape only over the coming months and years. However, group structures can and should be reviewed to identify areas where a cessation of EU membership could cause tax leakage, and consideration given to the possibility of pre-emptive restructurings before the UK formally exits the EU. Tax directors will also need to be involved closely in wider investment decisions to ensure that the tax implications of the UK being outside the EU are properly factored in. And it will be important that businesses and tax professionals engage actively with government regarding the shape of any future agreement with the EU from a tax perspective. ■