Fried Frank

BREXIT Alert

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The “Phoney Brexit”: a Tax Guide

A period of “Phoney Brexit”

After the Brexit vote, the UK now faces a prolonged period of uncertainty whilst the legal arrangements for its exit from the EU are planned and negotiated. The EU Treaty contemplates a period of up to two years, or longer, between a member state notifying its intention to leave and the effective date of exit, and the UK has yet to give that formal notice. As a result, in many respects we are now experiencing a period of “Phoney Brexit”, when nothing has as yet really changed. Does this mean there’s no immediate need for businesses to respond?

It certainly seems too early to take any action, but it does make sense to begin to plan. Even planning is difficult at this stage, however, as the form of the eventual relationship between an independent UK and the residual EU at the end of the separation process is very unclear. It may well be that not a great deal will change from a cross-border tax perspective.

But what should businesses be considering now from a tax perspective? Relevant tax considerations won’t necessarily arise just from tax law changes, of course. For example, if regulatory changes push a UK business to consider restructuring, or even to consider leaving the UK entirely, the tax implications of any such proposal will have to be considered.

What are the tax benefits of EU membership that could be lost?

The availability of EU law rights to UK taxpayers has provided various benefits, particularly over the last decade or so, as advisors have increasingly recognised the opportunities. These benefits, which have contributed to the attractiveness of the UK as a place to do business, are now under threat.

UK domestic aspects**:** Whether or not certain of these rights, as implemented in the UK, are to be lost in an independent UK tax system will be a matter of post-Brexit UK tax policy, on which there is no information as yet. Aspects of the UK’s CFC rules, and similar **anti-avoidance** rules relating to offshore income and capital gains, have been blunted in relation to income and gains arising within the EU, and Brexit may provide an opportunity for re-sharpening. Similarly, the availability of non-UK trading **losses** to be offset against UK profits within the same corporate group (a right won by taxpayers under EU law) could be removed. The right of certain companies **migrating** out of the UK to defer the payment of exit taxes was only introduced to comply with EU obligations, and could be reversed. More fundamental aspects of the current UK tax system, such as the corporation tax **exemption for dividends** introduced in 2009, were also influenced by the UK’s obligations under EU law, but the need to keep the UK as an attractive place to do business may prevent changes here.

Cross-border aspects**: The** potential loss of other benefits of EU membership for UK taxpayers falls outside the UK’s control, however. Most obviously, UK companies in corporate groups currently benefit from a **withholding tax exemption** on interest, dividends and royalties received from EU subsidiaries. Unless the residual EU States agree otherwise, UK companies will lose this benefit when the UK leaves the EU. Although in many cases the UK's bilateral double tax treaty network will provide an alternative exemption, that will not always be the case, particularly in relation to dividends (for example, in relation to dividends from German and Italian subsidiaries). The UK has been chosen by many businesses as an ideal holding jurisdiction in recent years, in many cases because of the ability to receive dividends from the EU without withholding and pay them on without leakage (due to the UK's dividend exemption and absence of a dividend withholding tax since 1999), and affected groups are likely to need to consider a possible restructuring.

***Non-UK aspects*:** Beyond inbound withholding tax issues, the UK's status as an EU Member State is potentially relevant to the **treatment of UK companies** for the purposes of other Member States' tax systems. UK companies may become increasingly affected by residual EU States' CFC rules, and dividends paid by such companies may perhaps become taxable for residual EU parents, for example.

Other potential changes

***VAT*:** It seems unlikely that the UK will reform its VAT system significantly in the immediate future, albeit that the current system, though implemented through UK legislation, is founded in EU law. The treatment of supplies into the EU will be a key focus. An interesting question will be whether UK based financial institutions could in the future significantly improve their UK VAT **recovery rate** because, going forward, the current favourable input tax recovery position on cross-border supplies made from the UK to non-EU customers could perhaps apply on supplies to residual EU customers too. That could make London a more attractive place for some financial businesses.

***EU Financial Transaction Tax ("FTT")*:** The UK was already outside the group of 10 EU States working towards the introduction of an EU FTT, the implementation of which still remains uncertain. The main impact of Brexit seems likely to be that, as an outsider, the UK will now be unable to mount further legal challenges to any FTT proposal, which perhaps makes the FTT proposal now **more likely**, rather than less likely, to be realised. As previously noted by many commentators, the intended breadth of application of the FTT means that financial transactions with only tenuous connections to the FTT-implementing states may well be affected, and so a post-Brexit UK may find itself (as with FATCA) adversely affected by international measures.

***Stamp taxes*:** HMRC's current practice of not enforcing the payment of 1.5% **stamp tax** on the issuance of shares into depositary and clearance systems is based on EU law, so this is another area in which benefits enjoyed by taxpayers may be negatively affected by Brexit.

UK tax policy – the new offshore haven?

The general policy response to Brexit remains to be formulated, but George Osborne (subsequently superseded by Philip Hammond as Chancellor of the Exchequer) initially indicated an intention to reduce the UK corporation tax rate to just 15% to support investment into the UK in the uncertain environment. The direction of Theresa May's new government is yet to be seen. However, it is clear that the UK will need to maintain a competitive edge, and so some "improvements" to the business tax environment seem likely. Some commentators have suggested that these pressures to attract business to the UK may also slow the UK's accelerated plan to implement the OECD's BEPS recommendations (for example, the interest deductibility restriction at 30% of EBITDA, which is scheduled to apply from April 2017), but this seems unlikely in the wider political context.

Potential restructurings – head for the door?

In almost all cases, "wait and see" is the only practical response at the moment. The ability to sensibly plan for Brexit is hindered by the lack of clarity as to the likely post-Brexit relationship between the UK and the residual EU. Taxpayers can be reassured that the potentially lengthy period of up to two years or more between the UK formally notifying its intention to leave the EU and that becoming a legal reality should give them time to plan, although it seems unlikely that all uncertainties will be resolved in that period.

Businesses that consider restructuring out of the UK should bear in mind that:

- To the extent that the tax neutrality of a restructuring depends upon the EU's Cross-Border Mergers Directive, the window of opportunity may close on the UK's formal exit from the EU. This may apply some time pressure to restructuring proposals in due course.
- The current state of the UK's domestic tax regime in general terms facilitates tax neutral corporate restructurings, with in particular a "substantial shareholdings exemption" for capital gains. However, in an uncertain political environment, it may be unwise to delay implementation following identification of a beneficial restructuring plan.
- For businesses migrating out of the UK, a transfer of goodwill to a related party may be deemed to have occurred at market value (regardless of any actual value passing). HM Revenue & Customs may pay increased attention to this potential taxing opportunity where taxable activities are moved from out of the UK into residual EU territories.
- If activities are split between an existing UK entity and a newly established EU entity, as well as the usual transfer pricing issues, the UK's new Diverted Profits Tax may become relevant if the level of profit reported in the UK does not reflect the level of residual activity there.

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