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Legal Update
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Brexit: the tax implications

Introduction

Tax is collected in the UK on the basis of domestic legislation, enacted by the UK Parliament. Therefore, the UK's corporate tax code will most likely remain highly competitive and attractive for international businesses. The EU has, however, exerted some influence on the development of the UK tax code – several features of the UK's current tax system are derived from EU law, and decisions of the European Court of Justice have resulted in further changes to the UK tax system.

This note considers how UK tax law may change as a result of Brexit. Any such changes are unlikely to occur until the UK's negotiated withdrawal from the EU is complete (or, at least, well advanced). That process will take at least 2 years from the date of the UK's notification to the EU Council of its decision to withdraw, and finalising the negotiations between the UK and the EU as regards the UK's future relationship with the EU will likely take much longer. Until the 2 year period is over, the UK tax code continues to be subject to EU law.

Direct taxes

Direct taxes are imposed by UK law. The majority of the UK's current domestic body of direct tax law will remain in place – the UK's low corporate tax rate (currently 20%, planned to reduce to 17% by 2020), the exemptions related to dividends received from subsidiaries and gains made on sales of trading subsidiaries, the branch profits exemption, etc.

However, the UK's direct tax rules must be compatible with EU laws (such as free movement of capital, services, goods and people) and whilst UK tax law may no longer be constrained by EU laws, some EU Directives would no longer apply to UK companies. Clients may want to consider, for example:

- **The Parent Subsidiary Directive** - This provides relief from withholding taxes on the payment of dividends between associated companies in different EU states, and relieves the double taxation of parent companies on the profits of their subsidiaries. On the UK leaving the EU, UK parent companies will no longer benefit from this Directive, and will therefore need to rely on the terms of bilateral double tax treaties (**"DTT"**) between the UK and each member state to receive payments gross. The UK has the largest DTT network in the world (including with all EU member states), and relief is available in many (but not all) cases under the relevant DTT with EU members states. UK parent companies will in most cases benefit from the UK's domestic tax exemption for dividends received from subsidiaries. Because the UK does not impose withholding taxes on dividend payments, the UK tax position for dividends paid from UK companies to EU parent companies should not deteriorate as a result of the Parent Subsidiary Directive ceasing to apply; tax could, however, become due on receipt in the relevant member state.
- **The Interest and Royalties Directive** - Once the UK leaves the EU, the Interest and Royalties Directive will no longer relieve withholding taxes on royalty and interest payments between UK companies and associated companies in the EU. Unlike dividend payments, under UK domestic law withholding taxes may arise on interest and royalties, so payments to EU companies as well as from EU companies may be affected. It will therefore become necessary to consider what relief from interest and royalty withholding is available under the relevant DTT. Again, whilst relief is likely to be available in many cases due to the UK's extensive DTT network, full relief may not always be available. There are, however, a number of domestic exemptions on which Brexit should have little or no effect, such as the "quoted Eurobond exemption" (which relieves interest withholding on certain listed debt).

- **The Merger Directive** - The Merger Directive removes fiscal obstacles and offers tax relief to cross-border reorganisations. This may have a detrimental impact on companies and could give rise to increased tax charges on transfers of assets to and from the UK. The regime is enacted in UK law (e.g. TCGA 1992 s.140A). However, once the UK leaves the EU, any reference in the legislation to an EU Member State would not apply to the UK. The legislation would therefore, at the very least, need to be adapted. It could be removed entirely, which could add increased tax costs for UK businesses that are a party to merger transactions. It should be noted, however, that many of the UK's reorganisation provisions (e.g. TCGA 1992 s.135) are domestic law based, will not be impacted by Brexit and can apply in cross border situations, provided the relevant conditions are met.

Indirect taxes

Indirect taxes are also imposed by UK law, but UK law in this area derives from EU Directives and/or Regulations to a far greater extent than UK law related to direct tax. Clients may want to consider, for example:

- **VAT** - VAT is unlikely to be replaced or significantly changed in respect of domestic transactions immediately following the UK's departure from the EU. There is, however, likely to be a more significant impact on VAT for cross-border transactions within the EU. For example, current EU-wide principles mean that no UK VAT is imposed on cross-border supplies of goods or B2B services from the UK to a recipient in another EU member state. How VAT will work in cross border scenarios will be a key item to be negotiated as part of the UK's Brexit.
- **Customs duties** - Similarly to VAT, customs duties currently do not apply to trade within the EU; rates for imports from outside the EU are set at the EU level. Since (unlike VAT) these duties are largely governed by EU law, new legislation will be needed, both in relation to trade with EU member states and in relation to trade with non-EU countries (trade between those countries and the UK is currently governed by the agreements between those countries and the EU).
- **Excise duties** - UK excise duties are at present not fully harmonised with the EU; excise duties on goods such as tobacco are bound by minimum rates set by EU Directives (although the UK can set the rates above those thresholds). After the UK leaves the EU, it will be possible to vary the rates of excise duties without EU law restraints.
- **The Capital Duty Directive** – This imposes restrictions on member states imposing tax on the raising of capital by companies, such as share issues. The UK has, as a member of the EU, restricted the scope of its 1.5% stamp duty reserve tax (SDRT) charge on shares issues into a depository receipt issuers and clearance services. In principle, following Brexit, the UK could extend the scope of this charge without being constrained by EU law, though this is considered unlikely.

International investment and cross-border matters

The UK tax environment is most likely to remain attractive to international investors, given (as referred to above) the UK's low corporate tax rate, and the dividend and substantial shareholdings exemptions. There are however some areas which international investors should review and/or monitor as the Brexit negotiations progress. Investors should consider, for example:

- **Cross border tax cooperation** - There are a number of EU-wide tax programmes under development. For example, the introduction of a package of changes to tackle perceived tax avoidance; the introduction of a financial transaction tax on trades in financial instruments; and the possibility of a "Common Consolidated Corporate Tax Base". Post Brexit, the UK will not be involved in the discussion or implementation of these projects. However, the UK's exit from the EU should not directly affect other cross-border tax initiatives in which the UK is involved, such as the OECD's "Base Erosion and Profit Shifting" ("**BEPS**") programme and reporting regimes such as the OECD's common reporting standard ("**CRS**") and the US's Foreign Account Tax Compliance Act ("**FATCA**").

- **Withholding taxes** – as mentioned above, the UK has a domestic exemption from withholding tax on dividends paid. So far as interest is concerned, there are a number of domestic exemptions that are available from withholding tax on interest paid subject to certain conditions being met. It is likely that these exemptions will continue to be available, albeit that some changes may be required – for example, whilst the "quoted Eurobond exemption" may require some changes, it has long been available for bonds in non-euro currencies (such as UK sterling or US dollars) that are listed in recognised stock exchanges in the UK, in the EU, or outside of the EU (such as NYSE, Nasdaq, the Canadian Stock Exchange, the Channel Islands Stock Exchange, etc). There is a UK withholding tax on royalties paid from the UK, and here investors should consider applicable DTTs if they have previously relied upon the Interest and Royalties Directive – see above. Further, the loss of the benefit of the Parent Subsidiary Directive and the Interest and Royalties Directive may mean that UK recipients of payments from EU members states may need to rely on the terms of the relevant DTT with the UK.
- **DTTs** (**UK and non-UK**) – the UK's large network of DTTs will remain in place and in force. But depending on the outcome of the Brexit negotiations, international investors should consider the impact of Brexit on whether they satisfy LOB provisions in DTTs generally, not just the UK's DTTs. For example, many treaties have an "equivalent beneficiaries" or similar concept, whereby a company can claim treaty benefits if it is owned as to a certain percentage by equivalent beneficiaries and certain other tests are met. Equivalent beneficiaries residents in member states of the EU (and the UK will cease to be such a member state), but it may also include member states of the EEA or the EFTA (and the UK may remain or become such a member state).
- **Domestic provisions related to international tax** – the UK's domestic law related to international direct tax – such as the UK transfer pricing code, the UK's CFC rules, and the new diverted profits tax – will most likely be unaffected by Brexit in material terms. Likewise, the taxation of non-resident investors in (for example) UK real estate is unlikely to be materially impacted. As stated above, in relation to indirect tax, and particularly for clients that have considerable trade in goods or services with EU counterparties from or via the UK, much will depend on the Brexit negotiations.

If you have any questions or comments in relation to the above, please contact the authors or your usual Mayer Brown contact. Clients should consider reviewing their international tax structures (and, if necessary, whether any restructuring may be required). We would be delighted to discuss and assist.

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