ALLEN & OVERY

Brexit – legal consequences for commercial parties

Tax and the implications of Brexit

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Issue in focus

The EU is a customs union as well as a single market. Fiscal matters were at the heart of the EEC at its establishment, and this continues to be the case for the EU today. As a customs union, there are no customs duties within the EU's territory, and Member States share common external tariffs with third countries. As a single market, it shares a VAT system that is harmonised and charged on a consistent and integrated basis across the whole of its territory. VAT funds a part of its budget and is paid by its hundreds of millions of citizens.

The position is different for corporate income taxes. The EU treaties do not require or even contemplate their harmonisation. While a handful of Directives target specific obstacles to cross-border activity, such as withholding taxes and tax charges on cross-border mergers, it was envisaged that corporate income taxes would remain within national competencies. However, in recent years an activist Court of Justice of the European Union (**CJEU**) and an increasingly proactive Commission have significantly restricted Member States' freedom within the tax area through proceedings for state aid, for discrimination and for restrictions of the fundamental freedoms.

Therefore, while corporate income taxes may not be harmonised in the way that VAT and customs duties are, membership of the EU has nevertheless had a fundamental effect on parts of the UK's tax code, such as the controlled foreign companies, transfer pricing and corporate distribution rules.

The erosion of fiscal sovereignty that comes with membership of the EU is unusual in the international arena, and may well increase in the future. Over the past 15 years, the Commission has become more and more active in pushing its agenda for further integration. This has culminated in the call for a "Common Consolidated Corporate Tax Base" (or **CCCTB**): a single set of rules applied consistently across the EU. While Member States would be able to choose the tax rate that suits them, the rules for computing taxable profits would be set at the level of the EU: a single corporate income tax system to match the single VAT system.

Not all Member States support this, and perhaps the most vocal opponent is the UK. However, recognition amongst Member States – and their electorates – of the need for co-operation in the international tax arena to eliminate perceived unfair advantages for multinational groups means that it is now more likely than at any time previously that some of these ideas will gain traction.

This paper explores how a Brexit might impact each of these areas – customs duties, value added tax and corporate income taxes.

Analysis

Customs Union

It seems highly likely that if the UK were to leave the EU, it would also cease to be a part of the customs union. While there is precedent for a third country to be a part of the EU's customs union (Turkey), this seems particularly unlikely here. One of the main benefits for the UK of Brexit is thought to be the ability to negotiate free trade agreements with the likes of the Commonwealth or NAFTA.

If so, exports between the UK and the EU would need to go through customs procedures. This would be cumbersome, but manageable. Norway is in the same position.

The reintroduction of customs procedures is unlikely to mean that we would see the imposition of very significant customs duties. The fall-back position for imports from the UK into the EU would be the EU's WTO "most-favoured nations" duties, which are significantly lower than they were 20 years ago or even 10 years ago. Nevertheless, they would inevitably put UK business to some disadvantage when compared with competitors within the EU.

We would hope that the UK and the EU would do better than this and enter into a free trade agreement with no or very low customs duties (whether because the UK joins the EEA, or more likely through bilateral agreement). This will be important for the UK: around one-half of UK exports are to the EU. While only around 10% of exports from the EU are to the UK, most EU countries benefit from significant trade in goods surpluses with the UK; in particular, Germany, Belgium, the Netherlands, Spain, France and Italy. That said, it is not inevitable that such economic considerations will be determinative here. There may be other political considerations in play.

Value added tax

The EU is about free trade, and multiple different sales taxes across the EU would have distorted competition within the single market and inhibited that free trade. VAT has therefore been harmonised within the EU since 1977. Following Brexit, the UK would sit outside of the territorial scope of EU VAT. It would therefore be open to the UK to change how VAT is charged in the UK, or even to replace it with an entirely different tax.

While one might well expect some vote-winning VAT reliefs, significant change (in particular to the architecture of the VAT system) in the short term seems unlikely. The cost to UK business would be unnecessary and too great. However, over time we could see some divergence, although the risk of double taxation or double non-taxation may well incentivise the UK to keep its VAT system materially aligned with the EU's.

The most tangible consequence of Brexit would likely be the imposition of "import" VAT when goods enter the EU from the UK, and when EU goods enter the UK. The VAT would often be recoverable – but there may be an unwelcome cashflow cost for the period between import and recovery for many businesses.

Withholding taxes

To date the EU has implemented a number of harmonising Directives intended to support the freedom of establishment. The most important are the Parent-Subsidiary Directive and the Interest and Royalty Directive, which prohibit withholding taxes on intra-group interest, dividend and royalty payments made within the EU.

The UK acts as a foreign direct investment gateway into the EU. Half of all EU headquarters of third party multinationals are based in the UK. The main EU recipients of investment from the UK are the Netherlands, Luxembourg, France, Ireland, Germany, Sweden, Spain, Belgium and Italy.

EU subsidiaries would not be able to rely on these Directives to be able to pay dividends or interest to their UK holding companies free from withholding taxes. Relief under bilateral double tax treaties would be an alternative, and in many cases would also eliminate withholding taxes entirely. However, not all treaties provide for a 0% withholding tax. For example, problems may persist in relation to dividends paid by German or Italian subsidiaries.

A significant amount of foreign direct investment into the UK also comes from the EU (over 85% of which comes from France, Germany, Luxembourg, the Netherlands and Spain). The UK does not impose dividend withholding taxes. It does impose interest and royalty withholding taxes, although generally treaties with EU member states reduce the withholding rates to

0%. Again, this is not always the case. For example, the treaty rate for withholding taxes on royalties paid to Luxembourg is 5%.

Overall, we would expect the withholding tax position to be generally manageable because of the UK's many double tax treaties. Nevertheless, they will not be a complete panacea.

CJEU case law and State Aid proceedings

The Commission has been active in challenging the domestic tax laws of Member States before the CJEU on the basis that they are discriminatory, contravene one or more of the fundamental freedoms or constitute state aid. If the UK were to join the EEA then it would continue to be subject to these restrictions. Otherwise, it would not.

A good example of such a challenge is the decision that EU controlled foreign company rules (that is, rules which tax a parent directly on the profits earned by a subsidiary established in a low or no tax jurisdiction) cannot apply to subsidiaries established in another EU Member State unless the arrangements are "wholly artificial". Otherwise the rules would deter businesses from exercising their freedom of establishment in other Member States, even those with low effective tax rates.

At some point after Brexit we may see the UK reintroduce UK tax rules that have been held to be contrary to EU law. This would usually require positive legislative change and therefore a policy decision to be made. Even if it were to happen it would likely take some time. This however will not always be the case. Some UK rules remain on the statute book even though they have been held to be contrary to EU law and so would likely become effective automatically were the UK to leave the EU. The 1.5% stamp duty charge on UK shares issued into clearing systems such as Euroclear, Clearstream and DTC is one example.

Conversely, we may see EU Member States applying anti-avoidance rules to arrangements with UK businesses that previously would have been exempted. Again, this may happen automatically where, as would commonly be the case, the exemption is limited to EU countries. By leaving the EU such exemptions could therefore cease to apply to UK businesses automatically.

Tax-related state aid investigations are becoming more high profile. The United Kingdom would have more scope to adopt competitive tax regimes that have been found to be or would be contrary to state aid rules.

Future of corporate income tax within the EU

The EU is at a crossroads now in terms of where it will go with corporate income taxes. The Commission is pushing hard for full harmonisation by introducing the CCCTB. Adoption of the CCCTB across the whole EU requires unanimous consent. It is difficult to know how much real support for the CCCTB there is among Member States, but we do know that the UK is a particularly vocal opponent.

Even if we do not see a CCCTB, further integration still reflects the direction of travel. In June 2015 the Commission proposed an Action Plan for "A Fair and Efficient Corporate Tax System in the European Union", and in January of this year published a draft "Anti-Avoidance Directive". Both of these proposals are intended to harmonise the EU's corporate income tax systems to some extent and are currently under discussion.

We would not be surprised if the most significant impact of a Brexit, both for the UK and for the EU, would be in respect of the future harmonisation of corporate income taxes. For the UK, it would mean the retention of sovereignty over fiscal matters. For the rest of the EU, there is the possibility that a Brexit could accelerate the harmonisation of corporate income taxes. This will not necessarily be the case; there are other Member States that are opposed to further harmonisation. However, the loss of a large and influential Member State that is opposed to it could be decisive.

What does this mean for you?

For now, the most that we believe can sensibly be done is a degree of contingency planning, particularly in terms of how a loss of the benefits of the Parent-Subsidiary Directive or Interest and Royalty Directive would affect group structures.

Otherwise, too much will rest on what the post-Brexit relationship between the UK and the EU would look like to predict with any degree of accuracy how it might impact your business from a tax perspective.

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