BREXIT: PREPARING FOR CHANGE

The tax implications – June 2016

Introduction

The result of the referendum for the UK to leave the EU was announced in the early hours of last Friday morning; a result with potentially very significant economic implications for the country. However, this is only the start, as the UK will not actually leave the EU for at least another two years, so whilst there is now a period of uncertainty for business, there is also time for the UK to start taking necessary action.

In this article, we consider some of the tax implications of Brexit. As there will be no immediate change, it is not necessary or advisable for you to take precipitate action on tax matters, especially since we do not know what action will yet be taken by the UK Government.

Indirect taxes

The EU is a customs union, which means that goods can be supplied freely within the EU (and European Economic Area) without the imposition of customs duties. Unless the UK negotiates a trade agreement with the EU, exports and imports of goods between the UK and the EU will be hit by customs duties and import VAT. This will reduce the attractiveness of our exports as they will be more costly to purchasers in the EU, and in turn, our purchases from the EU would also be more costly. Businesses based in the UK importing from outside the EU and then selling on to customers in the EU will need to take into account possible additional duty costs and / or administration. The ramifications will extend beyond the EU as well, since the EU has negotiated favourable trading terms with other countries and businesses may need to review their supply chains. We are in uncharted waters here: the UK has not negotiated new trade agreements in years, so we do not know how long it will take to put new agreements in place. However, in the short term there will be no effect as the customs union will be preserved until the UK actually leaves the EU.

As VAT is a European tax, UK VAT legislation has had to fall in line with the EU Principal VAT Directive. However, there is no practical chance that VAT will be abolished, as it is a major source of revenue for the UK, but the UK would no longer be bound by European constraints, for example over what can be zero rated and the rate at which VAT is charged. The UK has also had to repay significant amounts in VAT to businesses for failing to implement changes properly as required under European law; a costly mistake for the Treasury. However, whilst there may be more freedom for the UK government in formulating VAT policy in future, it is still likely that European VAT law would influence UK policy in order to deal with potential for tax avoidance and uncompetitive double taxation.

Direct taxes

Unlike VAT, corporation tax, income tax and capital gains tax are UK taxes, but this does not mean that Brexit will not have significant consequences. Over the past few years, the UK's direct taxes have been reshaped and remoulded as a result of successful challenges at the CJEU on the grounds that UK tax law breached any of the four fundamental freedoms enshrined in the EU

Treaty – freedom of establishment, free movement of capital, free movement of workers and free movement of goods. For example, the UK's group relief rules and controlled foreign companies rules were amended as a result of landmark cases won in Europe by Marks & Spencer and Cadbury Schweppes respectively. Similarly, changes have been made to ensure that there was no double taxation on individuals moving residence. However, it is not only likely that the UK will wish to encourage multinational / cross border activity and immigration of high net worth individuals and it will still have to observe these fundamental freedoms in reaching a trade agreement with the EU, so little may change in practice on that aspect.

Recently, the European Commission has started a number of State aid investigations into transfer pricing rulings granted by some Member States to multinational companies (Apple, Starbucks, McDonald's and Fiat). On leaving the EU, the UK would no longer be bound by the State aid rules. However, if it joins the European Economic Area, State aid legislation will continue to apply, which would be relevant in a number of areas. For example EU State Aid approval is required for various reliefs like EIS, EMI and R&D reliefs, so may continue to be the case but, again, it is likely such reliefs may impact the terms of any deal with the EU.

European Directives

The EU has a number of directives in place aimed at reducing tax burdens within the single market, notably withholding taxes.

The Parent/ Subsidiary Directive allows dividends to be paid by European subsidiaries to their EU parents free of withholding tax, and the Interest & Royalties Directive eliminates withholding taxes on interest and royalties. Whilst the UK does have an extensive network of double tax agreements to fall back on, not all eliminate withholding taxes on payments of dividends, interest and royalties between the taxpayers in the UK and EU Member States – some only reduce the rate of withholding tax that needs to be applied. In the UK, in the absence of a suitable treaty or EU Directive, payments of interest and royalties from the UK would be subject to withholding tax at 20%, meaning that the recipients may look for compensation through 'grossing up' clauses in legal agreements. As far as dividends are concerned, UK corporate recipients of dividends are normally exempt from corporation tax, so any withholding tax suffered would be an absolute cost. Conversely, on the payment of dividends by UK corporates, as the UK does not charge withholding tax on dividends, this should not be an issue for EU recipients.

The EU Merger Directive facilitates cross border reorganisations within the EU by allowing exit taxes to be deferred. Again, this Directive would no longer apply.

However, it is likely that the UK will seek to renegotiate a deal which will maintain these beneficial arrangements, as it will be in the interests of both the UK and EU Member States to facilitate international trade, but the question is how long will this take and what will it cost?

The EU has drafted an anti-tax avoidance directive, for approval by the European Council. As the UK has been a driving force behind the OECD-G20 BEPS project, the UK is already ahead of the curve in implementing the various anti-avoidance rules, such as a general anti-abuse rule, CFC rules. However, anti-hybrid rules are in Finance Bill 2016, and there is a question mark now hanging over the Finance Bill, since it would need to obtain Royal Assent by mid-October if it is to be enacted. A big issue for multinationals is undoubtedly the question of corporate interest deductibility, (broadly) set to be capped at 30% of EBITDA, which is also in the draft EU directive. However, as this was driven by the OECD-G20, it is highly unlikely the UK will shy away from this now.

Share schemes

The biggest share scheme opportunity post Brexit for entrepreneurial business is in relation to Enterprise Management Incentives (EMI). Currently constrained by State Aid regulations that limit the tax reliefs afforded on a selective basis to certain commercial undertakings we may now see the UK government free to enact domestic legislation that enhances and extends this very popular share plan in the UK. Indeed, given that EMI was introduced in 2000 with the stated political and economic aim of making the UK a highly attractive place for fast growth business and skilled global talent it would be surprising if we didn't see this arrangement opened up to larger companies (the 250 employee limit was EU imposed) as a means of attracting and retaining key people and rewarding them for business growth. For quoted companies the troublesome incoming Market Abuse Regulation (MAR) rules (EU imposed) may now be short-lived. For those companies offering equity incentives internationally there will be a need to consider how this will operate absent the EU prospectus exemptions that apply cross-border in the EU currently. We therefore anticipate a greater need for advice in what is set to become a more onerous securities law regime for global share plans.

Individuals and personal tax

As the process of leaving the EU unfolds it is inevitable that the issues around immigration and inbound investment will continue to be debated. Changes have already been announced to try to increase the UK tax take from wealthy individuals who make the UK their home for the long term. Greater flexibility to offer incentives to invest without breaching current EU state aid restrictions could lead to additional inbound investment. Ultimately, whether the UK sees more or less investment from overseas is likely to depend on whether such decisions are made principally for economic or political gain.

Individuals who own properties in other EU states could find that they are no longer protected from the punitive tax and social charges that are imposed by some EU countries on non-EU/EEA nationals (such as France where taxes on capital gains can be as much as 49%). Future negotiations between Britain and the EU may secure continued protection but we will have to wait and see. Protection from paying tax twice comes from double tax treaties agreed between the UK and other EU countries so this should remain – even if the overall rate of tax increases.

Employee mobility

UK workers in Europe are only required to pay social security contributions in one Member State. Again, it is to be hoped that an agreement can be reached so that such arrangements can continue, otherwise workers and businesses will suffer additional costs.

Employers of European nationals will be questioning what Brexit means for them and their employees going forward. The campaign placed so much emphasis on immigration that it will probably be fairly high up on the agenda once negotiations begin. The UK would probably look to extend the existing points-based system for non-EU nationals to EU nationals, subject to relaxations to meet European Economic Area requirements.

The effects are likely to affect low-paid, less skilled roles, so it is very possible that for the first time since the introduction of the PBS back in 2008 we will see more stringent points-scoring criteria and selective relaxations for specific sectors or industries where we are experiencing shortages. An overall cap on numbers is also a very strong possibility given the current climate.

The greatest certainty is that there will be costs involved unfortunately, both for the UK employer and the migrant themselves, as well as additional likely administrative burdens. Employers should factor in the need for Brexit reviews of global mobility costs and risk plans for the next two years onwards.

Conclusion

There is undoubtedly a period of considerable uncertainty for the UK, which is not good news for business. However, the full impact of Brexit may be softened by the UK renegotiating replacement deals with the EU. The great unknown is how favourable these will be and how long this will take as no one has done this before. We do not know at this stage how multinational business will view Brexit: whether multinationals may move their headquarters out of the UK, or whether the potential for less regulation could be seen as attractive. As noted at the start of this article, it is too early at this stage to assess what the final tax implications will be, and given there will be at least a period of two years to negotiate the exit, immediate action is not necessary.

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