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Brexit: Groups of Companies and Tax Treaties

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After Brexit, the U.K. will no longer be bound by the EU directives concerning tax matters and by the case law of the CJEU. This could have a significant impact on groups of companies that include British subsidiaries. This article provides an analysis of the possible consequences (and solutions) with regard to direct taxes.

On January 17, 2017 the Prime Minister of the U.K. gave a comprehensive speech at Lancaster House in which she informed the British people and the rest of the world about the intended objectives and consequences of Brexit. One of the most important objectives of Brexit is to take control of British laws and to bring an end to the jurisdiction of the Court of Justice of the European Union ("CJEU") in the U.K. The U.K. wishes their laws to be made within the U.K. and interpreted by British judges rather than a European court.

Once Brexit occurs, the U.K. will no longer be bound by the European Union ("EU") directives concerning tax matters and by the case law of the CJEU: this could have a significant impact on groups of companies that include British subsidiaries. This article provides an analysis of the possible consequences (and solutions) with regard to direct taxes.

EU Directives and Tax Treaties

When the EU directives cease to apply to British companies, the tax treaties that are concluded by the U.K. will regain their relevance in situations where the directives used to apply. Most of the directives, however, are already implemented in British tax law, and therefore it remains unclear whether the rules which have transposed the specific EU directives will stay in force after Brexit, or whether they will be included in the Great Repeal Act.

It is however also possible that the U.K. and the EU will negotiate a deal in which part of the directives stay in force, or a new regulation with similar effects comes into force. The most relevant EU directives are:

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- the Parent-Subsidiary Directive (2015/121);
- the Merger Directive (2009/133);
- the Interest and Royalty Directive (2003/49); and
- the Anti-Tax Avoidance Directive (2016/1164).*

**This directive is not yet implemented but the U.K. might be obliged to implement it before Brexit takes place.*

The Parent-Subsidiary Directive

Pursuant to the Parent-Subsidiary Directive, all EU Member States have to refrain from levying a withholding tax on dividends that are paid by a subsidiary to its parent company if certain requirements—with regard to place of business, minimum interest and legal form—are met.

Since the U.K. will cease to be part of the EU and thus the internal market, the EU Member States will no longer be obliged to apply the Parent-Subsidiary Directive to dividends that are paid to a parent company in the U.K. Conversely, the U.K. will also no longer be bound by the Directive. The EU Member States and the U.K. will have to determine the dividend withholding tax rate pursuant to the relevant tax treaties. Some EU Member States—such as the Netherlands and France—levy a zero percent withholding tax rate under some conditions. From a British perspective, the Member States with the lowest dividend withholding tax rate will be the most competitive after Brexit.

The Merger Directive

Pursuant to the Merger Directive, capital gains that derive from cross-border mergers between companies—that are both situated in an EU Member State—are exempted from corporate income tax if certain requirements are met. Similarly to the Parent-Subsidiary Directive, the tax exemption from the Merger Directive will no longer apply to mergers with companies that are located in the U.K. after Brexit is completed.

The Interest and Royalty Directive

The Interest and Royalty Directive provides for an exemption of withholding tax on interest and royalties that are paid to an affiliated entity also located in an EU Member State.

Similarly to the Directives mentioned above, the withholding tax exemption will no longer be applied to interest and royalties that are paid to the U.K. The EU Member States and the U.K. will have to determine the interest and royalty withholding tax rate pursuant to the relevant tax treaties. EU Member States with the lowest or no interest and royalty withholding tax—such as the Netherlands and Luxembourg—will have the most favorable position after Brexit.

Tax Treaties and Withholding Tax Rates

As mentioned above, the tax treaties will regain their relevance in order to determine the rate of withholding tax on dividends, interest and royalties. Obviously the EU Member States that apply the lowest withholding tax rates will have the most favorable position after Brexit. This may have a certain impact on strategic decisions such as the location of subsidiaries of U.K. companies, the attribution of intangibles and the financial structuring of their use between companies of the same group, and the financing structures used by U.K. groups.

The chart contains the applicable tax rates for a number of EU Member States. Please note however that the U.K. does not levy withholding tax on paid in-

Treaty	Dividends		Interests	Royalties
	Normal tax rate	When a % of the capital is held		
Belgium	10%	0% *	10%	0%
France	15%	0% *	0%	0%
Germany	15%	5% *	0%	0%
Italy	15%	5% *	10%	8%
Luxembourg	15%	5% **	0%	5%
Portugal	15%	10% **	10%	5%
Netherlands	10%	0% *	0%	0%
Spain	10%	0% *	0%	0%

* The recipient of the dividends controls at least 10% of the voting power/capital

** The recipient of the dividends controls at least 25% of the voting power/capital terest and royalties: the tax rate that is mentioned in the chart will only apply to interest and royalties that are paid to British companies.

Brexit and Groups of Companies

EU tax law is not only composed of the tax directives which have been described above. A large part of the impact of EU law on domestic tax systems is attributable to the case law of the CJEU, which has issued numerous decisions based on the fundamental freedoms protected by the Treaty on the Functioning on the European Union ("TFEU"), such as the freedom of establishment or the freedom of capital movement. U.K. legislation itself has been considered inconsistent with EU primary law in several circumstances, with the effect that domestic legislation has been changed in order to take into account the consequences of the Court's judgments. When Brexit takes place, the U.K. will gain more freedom to legislate, since it will not have to abide by the fundamental principles of EU law.

A drawback of this evolution will however be that other Member States will no longer be obliged to implement some freedoms in their relationship with the U.K. (with the exception of the freedom of capital movement which is the only one to apply to third countries). This will certainly impact groups of companies in the following situations:

- cross-border offset of losses;
- possibility to form fiscal unities; and
- treaty access for permanent establishments.

Cross-border Offset of Losses

One of the doctrines that derives from the case law of the CJEU is the possibility of cross-border offset of losses. Based on the *Marks & Spencer* case (December 13, 2005, C-446/03) EU Member States—under very strict conditions—should allow a parent company to offset losses that are suffered in other EU Member States by its subsidiaries if the foreign losses cannot be set off against any profits locally (due to, for example, termination of the entity). It is well-known that the U.K. legislation, which was at stake in this case, had to be modified after 2005, and the question whether this modification was itself consistent with EU law gave rise to a second decision of the CJEU. After Brexit, this kind of endless scenario will no longer have to occur, since the U.K. will be relieved from the obligation to allow cross-border offset of losses. On the other hand, though, the losses of British subsidiaries will not have to be offset in EU Member States, which may turn out to be to the disadvantage of foreign groups acting in the U.K. through local subsidiaries.

Fiscal Unity Legislation

The CJEU has ruled that EU Member States must allow the formation of a fiscal unity between companies that are both owned by the same EU/European Economic Area ("EEA") parent company, based on the *SCA Group Holding BV* case (June 12, 2014, C-39/13). The CJEU also ruled in the *Société Papillon* case (November 28, 2008, C-418/07) that the formation of a fiscal unity between the parent and the sub-subsidiary must be allowed if the subsidiary is established in another EU/EEA Member State.

If the U.K. remains a member of the EEA, the possibility to form such fiscal unities will remain in force in EU Member States. If the U.K. leaves the EEA, EU Member States will no longer have to allow such types of fiscal unities if the subsidiary or shared parent is located in the U.K. Another practical issue arises for existing groups based on an "SCA Group Holding BV" or "Papillon" structure. Where the U.K. exits the EU/EEA area, these groups will not be eligible for domestic benefits connected to the existence of a group unity: the effect of this could be disastrous for a number of consolidated groups throughout Europe, which raises the question whether U.K. companies serving as intermediate companies in these groups should not consider transferring their head office to another EU Member State while they still enjoy the benefit of fundamental freedoms protected by the TFEU.

Treaty Benefits for Permanent Establishments

Based on the *Compagnie de Saint-Gobain* case (September 21, 1999, C-307/97) permanent establishments that are located in EU Member States can request certain tax benefits from the tax treaties that are concluded by these States. Note that this case law is—in principle—only applicable if the head office and permanent establishment are all located in EU Member States. The permanent establishments can therefore make use of reduced withholding tax rates and some treaty rights that are awarded in tax treaties that the EU Member State where the permanent establishment is located has concluded with other EU Member States or even third states (as in the *Saint-Gobain* case). After Brexit, permanent establishments of British companies will no longer be able to make use of this possibility.

Non-discrimination Clause in Tax Treaties

The U.K. and the EU Member States have concluded tax treaties which are based on the OECD Model Tax Treaty. Article 24 of this Model Tax Treaty contains a non-discrimination clause which could provide for an alternative to the principle of non-discrimination established by the case law of the CJEU regarding the fundamental freedoms, such as the freedom of capital or the freedom of establishment. Based on the anti-discrimination clause, permanent establishments and groups of companies will still be able to claim some of the tax benefits that derive from the case law of the CJEU.

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Article 24 section 3 of the OECD Model provides that taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. The Netherlands has included this anti-discrimination clause in Article 24 section 2 of the tax treaty between the Netherlands and the U.K.

Article 24 section 5 of the OECD Model may also have an impact on the tax treatment which will be applied to U.K. subsidiaries of parent companies established in another Member State, or conversely, to the EU subsidiaries of parent companies established in the U.K. It may for instance be argued that Article 24 section 5 has relevance with regard to the formation of an SCA Group Holding BV fiscal unity. Based on this provision, two companies established in an EU Member State might be allowed to form a fiscal unity where their common parent company is located in the U.K., provided that all the other conditions required by domestic legislation for the formation of such a consolidated group are fulfilled.

Interesting precedents may be quoted in this respect. In the Netherlands, the court of appeal Arnhem-Leeuwarden (April 26, 2016, nr. 15/00206) has ruled that four subsidiaries with a common Israeli parent company are allowed to form a fiscal unity. Since the anti-discrimination clause in the tax treaty between Israel and the Netherlands is similar to the anti-discrimination clause in the tax treaty between the U.K. and the Netherlands, it is possible to assume that the Dutch courts will draw a similar conclusion. There is also case law in Sweden (Supreme Court, SE: RA 1996 ref. 69 et SE: RA, September 24, 1998, 4676-1997, 1998 ref. 49), Finland (Supreme Court, FI: KHO, May 10, 2000, Decision KHO 10.05.2000/864) and the U.K. (Court of Appeal, October 17, 2012, [2012] EWCA Civ 1290, *FCE Bank plc)* which seems to share the interpretation of the anti-discrimination clause. Similar questions are also raised before tax courts in France.

Conclusion

Brexit may undeniably have severe consequences for groups of companies with entities in the U.K. All EU directives with regard to direct tax and subsequently the case law of the CJEU will cease to have legal force in the U.K. The bilateral tax treaties will regain their relevance with regard to the determination of withholding tax rates. A major impact of Brexit is therefore to trigger tax competition between Member States in their relationships with the U.K, with the effect that reorganizations may be anticipated in order to enjoy the best possible treatment on international payments involving U.K. companies.

Another impact of Brexit will be to raise interesting questions concerning the applicability of the non-discrimination provision enshrined in Article 24 of the OECD Model Tax Treaty with a view to securing that part of the *"acquis communautaire"* deriving from the case law of the CJEU remains applicable thanks to Treaty law.

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