CLIENT MEMORANDUM

United Kingdom – Tax Impact of Brexit on UK Holding Companies

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The UK referendum vote to leave the European Union (EU) (the so-called "Brexit") has generated queries about the impact (if any) on international corporate structures that include a UK holding company. For many groups, the current tax advantages of a UK holding company will survive Brexit.

Continuing Advantages of the UK as a Holding Company Jurisdiction

Many groups have chosen the UK as a location for an ultimate or intermediate holding company.

The relevant tax considerations were discussed in our article "What are the Tax Reasons Favouring the United Kingdom as a Holding Company Location for International Groups?" (which can be accessed here).

The attractiveness of the UK as a holding company location from the tax perspective is mainly due to features of UK domestic tax law that are not directly affected by EU membership; in particular:

- ***Tax-efficient dividend flows***: The UK does not levy withholding tax on outgoing dividends; and there is a full participation exemption for incoming dividends, provided the dividend falls within one of five exempt classes;

- ***Targeted CFC regime***: With regard to undistributed profits of subsidiaries, the UK controlled foreign companies regime is targeted at the artificial diversion of profits away from the UK and does not catch subsidiaries, even in low tax jurisdictions, that have genuine local business presence and activities;
- ***No UK tax on sale of operating subsidiaries***: There is a full participation exemption for capital gains realised on a sale of an operating subsidiary, provided the 12 month holding period and trading conditions are met;
- ***No UK tax on sale of shares in UK company by foreign shareholder***: The UK does not usually levy tax on non-resident shareholders on capital gains realised on a sale of shares in a UK company; and
- ***Deductible interest costs***: There are comparatively generous rules on interest deductibility, subject to thin capitalisation and transfer pricing rules, and, with effect from April 2017, a "fixed ratio" limit based on the recommendations in the OECD final reports on Base Erosion and Profit Shifting (the BEPS Reports).

In addition, of course, various commercial factors play a part in the choice of holding company location.

The tax advantages listed above are likely to remain. It would be very surprising for a future UK government to choose to make changes that could materially damage the attractiveness of the UK for international inbound or outbound investment.

Indeed, the UK government is currently consulting about possible improvements to the participation exemption for capital gains with the aim of making it simpler and more internationally competitive. In particular, it is considering changes to encourage the use of a UK company as a holding platform for the funds sector (including sovereign wealth funds, pension funds and tax-transparent private equity funds).

Impact of Brexit on Withholding Tax on Incoming Dividends from Selected EU Jurisdictions

One tax aspect that may need further analysis in the wake of the referendum result is withholding tax on incoming cash flows.

Income from non-EU subsidiaries will be unaffected.

However, Brexit may make a difference in relation to payments received from subsidiaries in certain EU countries. Under EU Council Directives, dividends, interest and royalties can be remitted intra group from one EU member state to another without suffering withholding tax. Brexit will mean that a UK holding company will no longer be protected by those Directives.

However, as far as dividends are concerned, in many cases, the EU Parent/Subsidiary Directive is actually superfluous because existing domestic law in the source state either does not impose withholding tax on dividends (like Hungary) or provides generous exemptions (like Ireland). In addition, even where, in principle, withholding does apply as a matter of local tax law, the rate may be reduced, often to nil, under the UK's double tax treaties. The UK has a bilateral tax treaty with all other EU member states.

In light of this, the impact of Brexit on inbound dividends is likely to be confined to subsidiaries in only a few countries. UK parent companies may suffer a 5% withholding tax on dividends from subsidiaries in Austria, Croatia, the Czech Republic, Germany, Italy and Romania, with a 10% rate applicable in Greece.

If the UK holding company makes loans or licenses IP to its subsidiaries, then, in principle, a similar situation applies. The EU Interest and Royalties Directive, which usually exempts intra-EU group interest and royalty payments from withholding tax, will, in due course, cease to apply and, therefore, Brexit will potentially affect interest/royalty income flows into the UK from EU (but not non-EU) subsidiaries. Again, the practical impact will depend on whether the source jurisdiction levies withholding tax at all and, if so, the terms of the relevant treaty with the UK. Many will provide a full exemption from interest/royalty withholding tax.

Alternative EU Holding Company Locations

If a UK company owns a subsidiary in one or more of the seven relevant EU countries and is an intermediate holding company in a wider international group, further analysis will be needed to determine whether any dividend withholding tax at the EU subsidiary level represents an incremental tax cost for the group as a whole. For example, if the ultimate parent is in the United States and can utilise the additional foreign tax credit generated by the extra withholding tax to reduce the U.S. tax charged on the repatriation of the relevant EU profits to the United States, there may not be any material adverse effect on the group as a whole under the existing group structure.

On the other hand, if the UK holding company is the ultimate parent of a widely held group, the dividend withholding tax will probably represent an incremental cost.

If so, the next question is whether the amounts involved are material and, if so, whether the situation can be improved by relocating the holding company. This needs to be examined in the round. As noted above, one of the advantages of the UK tax system is that the UK does not levy withholding tax on any dividends paid by a UK company. Therefore, relocating the holding company to another EU jurisdiction, in order to preserve the Directive exemption from withholding tax on incoming dividends, may not result in an overall tax saving if that other jurisdiction imposes its own withholding tax on outgoing dividends.

For this reason, the Netherlands may not offer any overall improvement as a possible alternative holding company location. A Dutch company might still be a solution as an additional intermediate holding company underneath the UK entity provided the "substance" requirements mentioned below can be satisfied.

On the other hand, in a private equity context, using a Dutch cooperative (as opposed to a company) as a holding entity for the fund's EU investments may be a viable alternative, subject to keeping an eye on a recent suggestion from the Dutch Deputy Minister of Finance, Eric Wiebes, that the exemption from withholding tax on distributions by a cooperative may be terminated, in certain circumstances, by 1 January 2018.

An Irish holding company could be suitable, depending on the identity of the ultimate shareholder(s), given the broad exemption from Irish dividend withholding tax in favour of a recipient who is resident in a treaty jurisdiction (regardless of the precise terms of that treaty).

If the post-Brexit cost solely concerns interest and royalties, it is worth noting that loans and IP licenses do not have to run parallel with shareholdings. It may make sense in that situation to retain the UK holding company but separate the equity structure from the group treasury/IP holding structure.

In all cases, attention will also need to be paid to the increasing scrutiny by tax authorities of local “substance”. The Parent/Subsidiary Directive was amended recently to include an anti-abuse rule to deny the benefit of the Directive in situations where dividends are artificially routed via an EU holding company in order to avoid withholding tax. In addition, the BEPS Reports recommended additional measures to deter “treaty shopping” (by incorporating a principal purpose test or a limitation on benefits rule in double tax treaties) to prevent the use of conduit companies to avoid withholding taxes. Therefore, any new structure will need to exist “on the ground” and not merely “on paper”.

Conclusion

A careful analysis of each particular set of facts is necessary.

If Brexit will result, in due course, in a material adverse effect, and if a relocation of the holding company to another EU jurisdiction can deliver an overall improvement, steps should be taken to implement the reorganisation over the next few years before Brexit takes effect, whilst the group can still take advantage of the special corporate and tax rules for intra-EU reorganisations.

In most cases, Brexit will have no effect on a UK holding company structure.

If you have any questions regarding this memorandum, please contact Judith Harger (+44 20 3580 4705, jharger@willkie.com) or the Willkie attorney with whom you regularly work.

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