A legislative tangle

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Gary Ashford considers the implications that the UK's departure from the EU will have on its international tax rules

Key Points

What is the issue?

Brexit has significant implications on the UK international tax rules. While the VAT rules had been a pan EU tax, direct taxes had mainly remained within the competency of member states. They have nevertheless been significantly impacted by the UK leaving the EU.

What does it mean for me?

A number of issues need to be considered post Brexit in terms of EU directives, including the EU Parent and Subsidiary Directive, the EU Royalties and Interest Directive, the EU Merger Directive and EU Directive of Administrative Cooperation, as well as Common Reporting Standards.

What can I take away?

Activities and transactions which have been taken for granted for many years now will need to be considered in detail, in particular to determine whether there will be a withholding tax deduction on an income flow.

It feels like a lifetime ago since the UK left the EU at midnight on the 31 December 2020, having secured a free trade agreement. This followed four years of political discussion, several Parliaments, two prime ministers and what amounted to two withdrawal agreements.

There is no doubt that Brexit has signifi cant implications on the UK international VAT rules. Prior to the UK's exit, VAT was (and continues to be for the 27 member states remaining in the EU)
a pan EU tax, administered nationally, by virtue of the VAT Directive. The details of the separation are compounded by the state of VAT in Northern Ireland and we propose to deal with this in a future article.

In contrast, direct taxes remained within the competency of member states, subject to Directives agreed unanimously by the member states. Direct taxes must also comply with the EU Treaties (especially the four freedoms) and meet EU state aid rules. The UK leaving the European Union means that we are no longer subject to the EU Directives, the EU Treaties and the EU state aid rules (although there are state aid limits in the free trade agreement).

A number of significant cases over the past years have demonstrated the significance of EU membership in terms of UK direct taxes. Most recently, the EU Commission has claimed that certain
national tax provisions and rulings amount to selective advantages under EU state aid rules under the Treaty on the Functioning of the European Union (TFEU) Article 107(1). In 2019, the Commission decided that aspects of the UK's controlled foreign companies' regime breached state aid rules (see bit.ly/3guxgOp) and HMRC sought recovery of the state aid element.

The same goes for reliefs, particularly some of the UK research and development reliefs and enterprise investment scheme reliefs for small and medium sized companies and their investors.

This article sets out some of the issues that need to be considered post Brexit in relation to the EU tax directives.

EU Parent and Subsidiary Directive

This directive (90/435/EC) was introduced on 1 January 1992.

The directive prevents the imposition of withholding taxes on dividends paid by a company resident in a member state to a company in another member state where the company receiving the dividend held at least 25% of the capital of the company paying the dividend.

The directive effectively overrode any withholding tax provisions between the two countries in any double taxation treaty. The rules extended to member states who joined the EU after 1 January 1992, from the date of their accession to the EU.

The UK leaving the EU brings the UK's compliance with the EU Parent and Subsidiary to an end. From 1 January 2021, therefore, we must turn again to any double tax treaties in place between the UK and the relevant country.

In terms of any dividends paid by UK companies, the UK abolished advance corporation tax (ACT) from 6 April 1999 and with that any withholding tax on dividends. This remains the case today. Therefore, after departure from the EU, a UK company paying a dividend to a parent company anywhere in the EU will continue to pay that dividend gross and without any deduction of income tax. This position is also the case on the payment by a UK company to an individual shareholder.

Therefore, consideration of the deduction and withholding of income tax in relation to dividends from a UK perspective will only become an issue when received by the UK parent company or by a UK resident individual shareholder.

Where an EU resident company (or for that matter a company resident anywhere outside the UK) is looking to pay a dividend to a UK company or individual and the country of that company's residence has rules to withhold income tax on that dividend, there may be scope to have the dividend paid gross, with the agreement of the tax authority of the paying company. However, this only applies where an effective double taxation agreement exists between the country of payment and the UK.

EU Royalties and Interest Directive The EU Royalties and Interest Directive prohibited the withholding of income tax on the payment of certain royalties or interest between associated companies, resident in different member states.

Unlike the position for the payment of dividends, mentioned above, the UK does in principle withhold income tax on the payment of interest and royalties. Therefore, with the UK no longer subject to the terms of this directive, any payment of interest or royalties will require careful consideration to determine whether income tax will need to be deducted and paid over to HMRC. The rate of income tax where required to be withheld is 20%, unless reduced by virtue of the terms of a specific double tax treaty.

Interest

It is important to appreciate that the UK does not withhold income tax on the payment of every type of interest. There are a number of exemptions, including for payments made by banks and building societies. The deduction of income tax is only applied on the payment of yearly interest.

Although there is no statutory definition of yearly interest, there is long held case law on the point.

At its simplest, yearly interest is interest on a loan which does not last longer than 12 months. However, as with many financial services matters, the devil is in the detail and the structure of a debt cannot be without complication. Under UK rules, the deduction of income tax is required at the point of payment, so there is no requirement at the point that interest is accrued or capitalised. That said, it is important to appreciate that there are separate tax rules on capitalised interest, which could accelerate the actual taxing point, but not yet trigger withholding tax if it has not yet been paid.

Royalties

The position on the deduction of income tax on the payment to royalties to non?residents has seen significant change and tightening by the government in recent years. In particular, Finance Act 2016 introduced a number of changes to the withholding of income tax rules, covering the following:

- anti?treaty shopping provisions (this was ahead of the implementation of BEPS Action 6 through the Multilateral Convention);
- broadening the definition of royalty for the withholding tax rules; and
- changing the rules to determine the UK as the source of the royalty.

The anti?treaty shopping rules were introduced in line with the BEPS Action 6 principal purpose test, so will come into play (via Income Tax Act 2007 s 917A) where there is a tax advantage.

The rules only apply for connected companies. Where the rules apply, they will prevent any deduction from corporation tax of any tax withheld.

The third point above is of particular interest, even though it is not specifically linked to Brexit. The UK territorial rules on miscellaneous income charge apply to UK tax income (including receipts from intellectual property) arising to a UK resident whether or not it is from a source in the UK. The rules also charge non?residents to UK tax on income if it is from a UK source. The 2016 changes have extended the rules on UK sources to royalties made in connection with a trade carried on through a permanent establishment in the UK.

Just as in many developed countries around the world, the taxation of intellectual property is of particular interest to the UK. It has been the subject of various developments in recent years, including the changes mentioned above and below, and the departure from the EU is likely to see an increase of activity in this area in the UK which may or may not reflect the developments occurring within the EU and as part of international agreements under the BEPS Inclusive Framework.

As well as the introduction of the diverted profits tax in 2015, the UK introduced the digital services tax from April 2020 (a 2% tax, where a group has global turnover of £500 million and UK sales linked to UK users of £25 million).

Less well appreciated are the rules introduced from April 2019 to tax offshore receipts in respect of intangible property (ORIP). The ORIP rules seek to tax foreign residents in the UK to the extent that intangible property is used directly or indirectly to enable, facilitate or promote UK sales of goods or services.

The withdrawal from the EU Royalties and Interest Directive will bring additional focus to payments made and received, and the underlying tax liabilities, as well as the direct impact in relation to withholding tax. This has been done by way of specific legislation within Finance Bill 2021, to take into account the specific tax exemptions held within various parts of the UK tax code.

EU Merger Directive

The EU Merger Directive was introduced on 23 July 1990 (Directive 90/434/EEC) to provide for a common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different member states and to the transfer of the registered offices between member

states. The rules were broadened in 2005.
The main effect of the Directive was to reduce barriers to group reorganisations within the EU, including limiting any capital gains risks on such reorganisations. The UK already had an extensive scheme of reliefs and thus the impact of the Merger Directive was often more relevant to possible tax charges in other member states.

I do not intend to go into the micro detail of the EU Tax Merger Directive and the loss of access to it as a result of Brexit; however, it will suffice to say that even though the UK has not repealed the legislation, as the UK is no longer a member state of the EU, EU members will deny access to the benefits to UK companies.

EU Directive of Administrative Cooperation (DAC)

The DAC is one of the key tools EU member states use to capture and exchange information automatically. In 2018, the sixth iteration of the DAC was introduced, implementing the BEPS Action 12, Mandatory Disclosure Reporting (MDR).

Under DAC 6, EU intermediaries are required to identify and report upon cross border arrangements which fall within a number of hallmarks (A to E). For some, reporting is restricted to those where a tax advantage is wholly or mainly the main purpose for those arrangements; i.e. the main benefit test.

On 29 December 2020, HMRC on behalf of the UK government confirmed that it will limit the implementation of DAC 6 to hallmark D only. At the same time, the UK will look to adopt disclosure rules based on the recommendations in BEPS Action 12. So what does hallmark D cover?

First of all, it is important to recognise that Hallmark D is not linked to the main benefit test, and so if arrangements are caught within the hallmark D conditions, they will be reportable regardless. But it is not the case that the motivations for the arrangements are ignored, because there is no link to the main benefit test (DAC 6 reports upon aggressive tax planning).

Common Reporting Standards (CRS) avoidance arrangements

The automatic exchange of financial account information

The first reporting requirement is on arrangements which have the effect of undermining the reporting obligation on the automatic exchange of financial account information, including with third countries. (This includes CRS reporting, but potentially could go further into other automatic exchange of information (AEOI) agreements.) The specific arrangements referred to include:

(a) the use of an account, product or investment that is not, or purports not to be, a financial account, but has features that are substantially similar to those of a financial account;

(b) the transfer of financial accounts or assets to, or the use of, jurisdictions that are not bound by the automatic exchange of financial account information with the state of residence of the relevant taxpayer;

(c) the reclassification of income and capital into products or payments that are not subject to the automatic exchange of financial account information;

(d) the transfer or conversion of a financial institution or a financial account, or the assets therein, into a financial institution or a financial account or assets not subject to reporting under the automatic exchange of financial account information;

(e) the use of legal entities, arrangements or structures that eliminate or purport to eliminate reporting of one or more account holders or controlling persons under the automatic exchange of financial account information; and

(f) arrangements that undermine, or exploit weaknesses in, the due diligence procedures used by financial institutions to comply with their obligations to report financial account information, including the use of jurisdictions with inadequate or weak regimes of enforcement of anti?money laundering legislation or with weak transparency requirements for legal persons or legal arrangements.

Whilst this is not within the DAC itself, the OECD guidance refers to the test of whether arrangements are CRS avoidance arrangements where ‘it is reasonable to conclude that it is designed to have, or marketed as having, the effect of circumventing CRS legislation’.

In terms of the test of reasonableness, the OECD guidance states that the test will be passed ‘where a reasonable person in the position of a professional adviser with a full understanding of the terms and consequences of the arrangements and the circumstances in which it is designed, marketed, and used, would come to this conclusion [CRS circumvention]’.

Opaque offshore structures

The second reporting category is for arrangements involving non?transparent legal or beneficial ownership chains involving the use of persons, legal arrangements or structures:

(a) that do not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises;
(b) that are incorporated, managed, resident, controlled or established in any jurisdiction other than the jurisdiction of residence of one of the beneficial owners; and
(c) where the beneficial owners are made unidentifiable.

As the UK amended its International Tax Compliance 2015 Regulations by the appropriate 2020 EU Withdrawal Regulations on 29 December 2020, the UK will continue to exchange hallmark D information with the EU.

Finally, on the point of DAC 6, it is worth appreciating that if the cross border arrangements are involving another (non?UK) EU member state, full reporting will still apply via any EU located EU intermediary, even though in the UK we will only be focusing on hallmark D.

HMRC will be consulting on the UK moving to OECD Mandatory Disclosure Regime reporting, which will be very similar to hallmark D reporting as it stands. If and when introduced to UK law, that will expand hallmark D reporting to all OECD member countries, and third countries agreeing to implement the Mandatory Disclosure Regime.

Conclusion

An interesting point will be whether the UK adapts its tax policy after EU membership, to set itself out as a great place to invest and do business, particularly in the new developing industries such as tech, green and bioscience. A significant aspect of much of the funding in those industries comes from grants and tax incentives, and we need to await how exactly state funding will be approached and implemented in the UK as they are freed from the restraints existing within the EU.

Finally, of note is the fact that the UK has specifically legislated to withdraw the key freedoms of the EU, notably freedom of establishment and freedom to provide services. No such legislative action has been taken in relation to the free movement of capital. Presumably, this is because that freedom is not limited to EU member states but extends to third countries. There are therefore questions around the continued access to this freedom for UK businesses and companies, which may provide a route into the EU single market. Previous commentaries on the thinking of freedom of movement of capital did indeed focus on the benefits to the EU of encouraging capital investment from outside its borders.