

Client Alert

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What Are the Tax Impacts of Brexit?

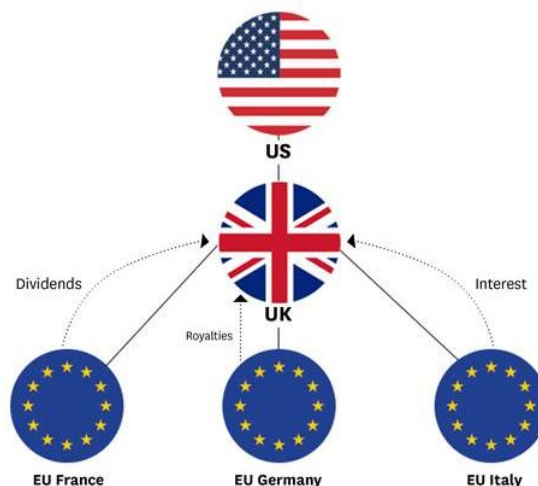
Brexit—the formal departure of the United Kingdom (the UK) from the European Union (the EU), pursuant to the referendum held in the UK in June 2016—is imminent: the UK will cease to be a member of the EU on March 29, 2019. In addition to the significant political and economic uncertainty currently being experienced by the UK in the run-up to Brexit, Brexit also creates some real-world and potentially significant tax issues for a variety of cross-border legal structures. Although Brexit should not generally have any direct impact on US taxpayers, it could impact structures and transactions in which US taxpayers participate. This client alert outlines two ways in which US taxpayers with interests in the EU could be affected.

Payments Between EU Companies

A US entity with EU subsidiaries (including under current law in the UK) could face an impact from Brexit. Specifically, payments of dividends, royalties or interest made by a subsidiary located in one EU state to a parent company located in another EU state are exempt from withholding taxes imposed by the state of the payer. The level of ownership required is in fact low: the ownership relationship required between payer and recipient is only 25 percent.

This changes post-Brexit. Following the enactment of Brexit, the UK will no longer be an EU state. Accordingly, UK companies will no longer qualify for this intra-EU withholding exemption. Consequently Brexit could have a material impact on any current transaction structure—or corporate group—where a UK company receives payments of dividends, royalties or interest from a previously qualifying subsidiary in the EU.

Take a specific example of a hypothetical US-headquartered multinational corporation with subsidiaries in the UK and other EU countries:



If the French, German or Italian subsidiary pays dividends, royalties or interest to the UK parent, under the exception to withholding described above, France, Germany and Italy would not impose any withholding tax on those payments.

Post-Brexit, this will no longer be the case. Instead, payments to the UK company could be subject to withholding on payments originating from the related companies in France, Germany or Italy. A tax credit might be available in the UK which would reduce the impact of any such withholding, but if the UK company has no tax liability (because, for example, the receipt of the dividend is exempt from tax in the UK) then such credit will be of no practical benefit.

The first step toward ameliorating this situation would be to seek relief under a double tax treaty in existence between the UK and the EU jurisdiction concerned, and to ascertain whether this relieves the imposition of withholding tax on such cash flows. These treaties are intergovernmental agreements which are already in existence and will not be impacted by the changes relating to Brexit.

It should be remembered, however, that even if a potentially helpful tax treaty is in place, typically a number of additional conditions would need to be satisfied for the tax treaty exemption to be available as a matter of practice. Each situation would need to be considered on the basis of the applicable facts.

The “Limitation of Benefits” Clause in US Tax Treaties

This separate issue also arises as a result of the UK’s loss of its status as an EU member state. As background, tax treaties between the US and EU countries tend to include a requirement that the EU resident party satisfies a “limitation of benefits” test to qualify for the benefits under the treaty. To qualify under the EU portion of the test, the EU party must qualify under one of several specified categories of persons. One typical category is that the EU party is itself owned by another EU company (an EU parent). Currently, a UK company can qualify as such an EU parent. Post-Brexit, however, this will no longer be the case, as Brexit involves the UK’s ceasing to be an EU member state.

Take the specific example of a lending transaction where a US borrower pays interest to a Luxembourg resident lender. The US-Luxembourg double tax treaty eliminates US withholding on the related interest payments. The Luxembourg lender will only be entitled to the benefit of that treaty exemption from US withholding, however, if it qualifies under the limitation of benefits test in the applicable tax treaty. If the Luxembourg lender is relying on the fact that it is owned by a UK company which currently qualifies as an EU parent, then, post-Brexit, this will no longer apply.

What does this mean in practice? It means that post-Brexit, absent satisfying any other of the limitation of benefits tests, the Luxembourg lender would no longer be entitled to the benefits of the treaty, and the interest paid by the US borrower may become subject to US withholding. Depending on the contractual arrangements (the drafting of the loan documentation), the US borrower may be required to compensate the lender for the cost of that withholding (in other words, a gross-up under a tax indemnity), and so this aspect of Brexit could ultimately be directly relevant to US taxpayers involved in similar transactions.

With the date of Brexit rapidly approaching, US companies should consider the potential impact Brexit could have on their current and future transactions. Hunton Andrews Kurth LLP will be pleased to discuss the potential relevance of this to your business, along with possible solutions.

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Hunton Andrews Kurth continues the expansion of its structured finance and specialty finance and tax and ERISA practices with the addition of David Klass, who joined the firm on January 2 as a partner in the London office. David brings more than 15 years of experience advising on a wide range of tax issues and transactions, particularly those with an international element. David has extensive experience advising clients on the tax aspects of cross-border mergers and acquisitions, structured finance transactions (advising both asset originators and arrangers), as well as the UK and international tax aspects of corporate group reorganizations. Read more about David's arrival [here](#).

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