Meijburg & Co
Tax Lawyers

Brexit: the tax consequences of the UK referendum

On June 23, 2016, the referendum to decide whether the United Kingdom (UK) should remain in or leave the European Union (EU) took place and resulted in a small majority of the British voters deciding in favor of leaving the EU. As this “Brexit” will necessarily have major consequences for both the UK and the EU, it is expected that defining the terms and conditions of such a withdrawal will take at least two years and involve challenging negotiations on both sides. Following this result, British Prime Minister David Cameron announced his intention to resign within the coming months.

In this memorandum we give an overview of the tax consequences and shortly address the impact for the Netherlands as regards direct taxes.

Background

On several occasions in 2013 and 2015, David Cameron, stated his intention to hold a referendum as to whether the UK should remain in or leave the EU. As the British Conservative Party won a parliamentary majority at the 2015 general election, the British government started negotiations with the EU on the future conditions for continued UK membership of the EU and in November Cameron set out the four areas (economic governance, competitiveness, sovereignty, and immigration) where he was seeking reforms.

During the European Council meeting of December 17, 2015, the question of the in/out referendum was raised and the Council accepted that it would work to find “mutually satisfactory solutions” regarding those four areas. In February 2016, an agreement was reached to strengthen the UK special status within the EU.

Following the negative outcome of today’s referendum, the UK will now have to start negotiations with the EU to give effect to this decision of the British people.

Tax consequences

The negative outcome of the UK referendum will potentially have a radical impact on the UK tax system, as European law impacts UK tax law both as regards direct and indirect taxation:

- UK direct taxation is subject to a number of EU directives, EU principles stemming from the Treaty on the Functioning of the European Union (TFEU) and the jurisdiction of the Court of Justice of the European Union (CJEU). In particular, UK domestic legislation cannot conflict with principles of EU law, such as the “four fundamental freedoms” and EU State aid provisions.

- VAT, as well as customs and excise duties, are all governed directly by EU legislation, which means that both the EU legislation and the CJEU case law are the main sources of UK indirect tax legislation.

- Membership of the EU gives UK companies access to the internal market (made up of 28 Member States) and to a wide network of preferential trade agreements between the EU and third countries.

Nevertheless, it is difficult to assess in detail how the Brexit will impact UK tax legislation in a near future, as this will mainly depend on the terms of any post-Brexit agreement to be concluded with the EU.

The Norwegian scenario
One possible scenario is that the UK becomes a member of the European Free Trade Association (“EFTA”) and retains access to the European Economic Area (EEA) and the customs agreements that EFTA has with the EU, similar to the current status of Norway. However, the UK will no longer be part of the EU VAT area, and will have to negotiate a bilateral trade agreement with the EU.

Under such a scenario, the EU principles enshrined in the TFUE, such as the fundamental freedoms and the State Aid regulations, would remain applicable to the UK. However, the UK would no longer benefit from the withholding and corporate income tax relief offered by the EU Directives (such as the Parent-Subsidiary Directive, the Interest and Royalties Directive, or the Merger Directive).

For the UK, membership of the EEA would still be synonymous with strong integration with the internal market.

The Swiss scenario
Another scenario is that the UK becomes a member of the EFTA, but does not join the EEA and negotiates a separate bilateral agreement with the EU, similar to the current status for Switzerland. If the UK chooses not to become part of any customs free trade area or trade association, the country would no longer be subject to EU legislation. In the context of portfolio investments in the EU, the UK will nevertheless – as any other non-EU country – still be able to benefit from the free movement of capital.

At present it seems unlikely that - at least in the short term - any major changes will be introduced in the UK tax system as a result of the referendum. EU Directives that have already been implemented in UK legislation as well as existing double tax treaties will most likely stay in place and should limit potential negative consequences for companies resident or active in the UK. While the UK will lose the benefit of the protection against discriminatory tax measures being imposed by other EU Member States, it will also regain the possibility of introducing tax incentives, for example, irrespective of the limits imposed by EU principles. Nevertheless, the extent to which the UK will face political pressure from the EU in this respect is still unknown.

Next steps
In principle, based on Article 50 of the Lisbon Treaty, the UK should notify the European Council of its intention to leave the EU and the EU will then negotiate and conclude an agreement with the UK, setting out the arrangements for its withdrawal, and a transitional period, taking account of the framework for its future relationship with the Union. For the purposes of those negotiations, the UK will not be represented in the EU's negotiating team.

It is currently expected that the UK government will send this notification to the European Council on short notice, but some British politicians are suggesting that it should not be done immediately, and preferably not before a new Prime Minister is appointed, which will not likely be until October. The withdrawal from the EU will become effective, either as of date of entry into force of the withdrawal agreement or two years after the notification. In view of this two-year notice period, the actual exit of the UK is unlikely to take place before June 2018.

Our comment
As the present circumstances constitute an unprecedented situation, it is clear that the full extent of the changes resulting from the UK referendum will not be known (or effective) for some time. However, it cannot be precluded that the Brexit will have important medium to long-term consequences for the UK tax system, especially as British tax rules will over time increasingly diverge from the EU rules. Although this might be mitigated by the expected political pressure to mirror EU changes to which the UK would be subject, Brexit is expected to lead to more complexities and administrative burden for multinationals active both in the UK and in the EU.

Impact for the Netherlands
At this stage it is impossible to predict what the outcome of the negotiations will be. In a worst case scenario where, for example, all directives on direct taxation would no longer be applicable, the taxpayers involved may seek protection under the 2008 Tax Treaty, including protocol and explanatory memorandum, between the Netherlands and the United Kingdom. This Treaty, inter alia, grants tax exemptions in the source State with respect to interest, royalties, qualifying intercompany dividends, as well as capital gains which are derived as the result of a corporate reorganization, amalgamation, division or similar transaction. Furthermore, this treaty grants non-discrimination and also provides for the resolution of cases by means of arbitration in cases where the competent authorities are unable to reach an agreement under the mutual agreement procedure within two years, at the request of the person who presented the case.

Client briefing by KPMG UK
If you would like, you can register for a client briefing by KPMG UK on Monday, June 27, 2016 at 14:00 CET, which will cover the initial steps organizations should be thinking about in response to an exit.

Meijburg & Co
June 2016