The Prospect of a Hard BREXIT: Considerations Regarding the Tax Treatment of Cross-border Investments

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The process of leaving the EU was initiated by a referendum held in June 2016 which favoured British withdrawal from the EU, commonly referred to as "Brexit", with a 52% majority. On 29 March 2017, the United Kingdom ("UK") gave formal notice to the European Council of its intention to withdraw from the European Union ("EU"). According to Article 50 of the Treaty on European Union, the UK and the EU have a two-year period to negotiate the withdrawal conditions and their future relationship. This negotiation period ends on 29 March 2019 and, in the absence of a withdrawal agreement approved and ratified by the UK and the EU, this means that the UK is scheduled to cease being a member of the EU on 30 March 2019.

Introduction

Over the last two years, the UK and the EU negotiated the terms of a withdrawal agreement that should define the relationship between the UK and the EU post-Brexit for a transitional or implementation period ending in December 2020 (unless it is extended for up to one or two years). The draft withdrawal agreement endorses a "soft" Brexit which would leave the UK's relationship with the EU as close as possible to the existing arrangements for the transitional period.

While the UK would no longer have a seat on the European Council and other EU institutions and governance structures, it would nevertheless be treated as if it were a member of the EU. The EU *acquis* would continue to apply to the UK, allowing it to keep unfettered access to the European single market. This means that goods and services would be traded with the remaining EU Member States on a tariff-free basis and financial firms would keep their "passporting" rights to sell services and operate branches in the EU. Moreover, the UK would remain within the EU's customs union, avoiding the need for border controls.

The withdrawal agreement has been endorsed on 25 November 2018 by the EU27 leaders of the European Council. However, on 15 January 2019, the House of Common's overwhelmingly rejected the withdrawal agreement with a record margin of 230 votes (by 432 votes to 202). The vote was originally scheduled for 11 December 2018 but postponed in light of the outspoken resistance by Members of Parliament.

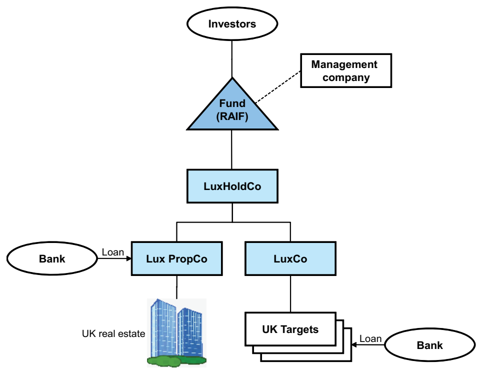
With less than two months left until the end of the negotiation period and no deal in sight, the prospect of a "hard" Brexit is more than a theoretical possibility. If the UK fails to agree on a withdrawal agreement with the EU, it will cease to be a member of the European Union and a party to the EU treaties. In this case, the UK would give up full access to the single market and the customs union along with the EU. According to studies, a hard Brexit would have devastating consequences for the UK economy and negatively impact the economies of EU Member States. All this creates unprecedented legal uncertainty for businesses and investors.

With regard to cross-border investments made via Luxembourg, the UK is one of the main investment locations for Alternative Investment Funds (real estate, private equity, etc.) and multinational groups. Likewise, investments made by UK fund groups and multinationals in the EU are often made through Luxembourg platforms (funds, holding companies, etc.). This article analyses the potential Luxembourg tax consequences of a hard BREXIT when it comes to cross-border investments involving the UK.

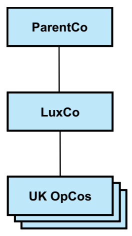
Considerations regarding UK Inbound Investments

Alternative Investments in the UK are typically made via a Luxembourg or foreign fund vehicle (the "Fund") and Luxembourg companies which acquire real properties or businesses. The Luxembourg investment platform of the Fund may, for example, consist of a Luxembourg master holding company ("LuxHoldCo") and separate Luxembourg companies ("LuxCo") for the different investments. The target companies (in the context of private equity investments) or property companies (in the context of real estate investments) are generally financed by a mix of equity and debt. Where debt funding is provided to subsidiaries, Luxembourg companies will commonly finance such receivables by debt instruments (for example, shareholder loans). When investments are held via two or more Luxembourg companies, the funds granted in the form of debt to the target companies may be routed via one or more Luxembourg companies.

Additional funding may be obtained by the operational companies or property companies from external sources (for example, banks). The following chart depicts how investments in the UK may be structured:



Multinational groups that manage their operational companies in Europe via a Luxembourg investment platform often hold participations in UK companies. The operational companies are commonly financed by a mix of debt and equity. In these circumstances, it is also possible that a Luxembourg company owns valuable IP rights that are licensed to subsidiaries in the UK.



With regard to investments in the UK, a potential hard Brexit may have an impact on the Luxembourg and UK tax treatment of income derived from UK sources:

Corporate income tax in the UK

UK corporate taxpayers are currently subject to tax at a rate of 19%. The UK Government announced a reduction of the corporate tax main rate to 17% for the year starting 1 April 2020. Luxembourg companies deriving income from real properties situated in the UK (rental income, capital gains) are subject to corporate income tax in the UK. According to the applicable tax treaty, such income is tax exempt in Luxembourg.

Dividend payments

Under UK tax law, no withholding tax is levied on dividend paid by a UK company. At the level of Luxembourg corporate shareholders, dividend income received from a UK subsidiary benefits from the Luxembourg participation exemption regime provided that certain conditions are met (a participation of at least 10% or with acquisition costs of at least EUR 1.2m, minimum holding period of 12 months). Even in a hard Brexit scenario, UK subsidiaries should remain qualifying participations under the Luxembourg participation exemption regime as UK companies meet the comparable taxation test (i.e. a taxation of at least 50% of the Luxembourg corporate income tax rate on a comparable tax base).

Interest payments

As a general rule, interest paid by UK companies is subject to UK withholding tax ("WHT") at a rate of 20%. However, if certain conditions are met, Luxembourg companies may claim a withholding tax exemption under the applicable tax treaty. This should not change in case of a potential hard Brexit. However, a new tax treaty is currently under negotiation between Luxembourg and the UK. The zero withholding tax rate which may currently be claimed in accordance with the UK law implementing the EU Interest and Royalty Directive (if certain conditions are met) would need to be monitored in case of a Brexit since the UK may consider repealing the WHT exemption applicable to interest payments to EU companies.

Royalty payments

UK domestic tax law generally subjects royalties arising in the UK to a WHT of 20%. Here, the applicable tax treaty provides for a reduced withholding tax rate of 5% if royalties are paid by a UK company to a Luxembourg company that is the beneficial owner of such income. This should not change in case of a potential hard Brexit. However, a new tax treaty is currently under negotiation between Luxembourg and the UK. The zero withholding tax rate which may currently be claimed in accordance with the UK law implementing the EU Interest and Royalty Directive (if certain conditions are met) would need to be monitored in case of a Brexit since the UK may consider repealing the WHT exemption applicable to royalty payments to EU companies.

Capital gains realized upon disposal of shares

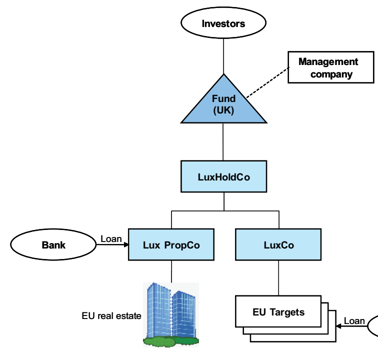
When a Luxembourg company disposes of shares in a UK subsidiary, the applicable tax treaty concluded between Luxembourg and the UK allocates an exclusive right to tax the capital gains to Luxembourg. Provided that the conditions of the Luxembourg participation exemption regime are met (a participation of at least 10% or with acquisition costs of at least EUR 6m, minimum holding period of 12 months), such capital gains are tax exempt in Luxembourg. Even in a hard Brexit scenario, UK subsidiaries should remain qualifying participations under the Luxembourg participation exemption regime. The new tax treaty that is currently being negotiated between Luxembourg and the UK will likely include a so-called "immovable property company clause". This means that capital gains realized by a Luxembourg company upon disposal of shares that derive at least 50% of their value directly or indirectly from real properties situated in the UK may in the future be taxed in the UK. Current UK law changes will seek to tax such gains under internal law with a clear tension with the existing treaty provisions.

Corporate reorganizations

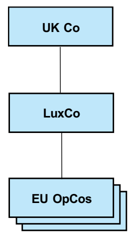
When UK subsidiaries of a Luxembourg company are merged, latent capital gains linked to the shares in the company that is absorbed may be rolled over to the shares received from the absorbing UK company (if certain conditions are met). As UK companies should satisfy the comparable taxation test, the Luxembourg roll-over relief should continue to apply in case of a hard Brexit.

Considerations regarding UK Outbound Investments

A potential hard Brexit may also have an impact on investments made by UK funds and multinationals via Luxembourg. An Alternative Investment Fund established in the UK may for example invest via a Luxembourg master holding company ("LuxHoldCo") and Luxembourg or local companies into real estate assets and businesses in the EU. These investments should generally be financed by a mixture of debt and equity. The following chart depicts how investments of UK funds may be made via Luxembourg:



UK multinationals may manage their operational companies in Europe via a Luxembourg investment platform. Here, the Luxembourg companies are generally financed by debt and equity.



With regard to UK outbound investments, the question arises whether a potential hard Brexit may adversely impact investments made via Luxembourg companies.

Dividend payments

Dividends payments made by Luxembourg companies are in general subject to a 15% WHT. However, dividends paid by a Luxembourg company to a UK company benefit from a domestic WHT exemption provided that the UK parent company owns a participation of at least 10% or with acquisition costs of EUR 1.2m for a minimum holding period of 12 months. The conditions of the Luxembourg WHT exemption may also be met when dividends are paid by a Luxembourg company to a UK fund vehicle that is treated as transparent from a Luxembourg tax perspective (e.g. an English LP) provided that the investors in the fund are taxable UK resident companies that satisfy the minimum holding requirements (i.e. minimum participation and holding period) with their indirect participation in the Luxembourg company. Given that the UK is a tax treaty jurisdiction and UK companies satisfy the comparable taxation test, the WHT exemption would also apply in case of a potential hard Brexit.

Interest payments

Under Luxembourg tax law, interest payments made by Luxembourg companies are not subject to Luxembourg WHT provided that the interest rate adheres to the arm's length standard. This would not change in case of a hard Brexit scenario.

Royalty payments

Royalties paid by Luxembourg companies are not subject to Luxembourg WHT provided that the royalty payments adhere to the arm's length standard. This would not change in case of a hard Brexit scenario.

Non-resident capital gains taxation

Non-resident shareholders of Luxembourg companies may be subject to Luxembourg capital gains taxation if they own a participation of more than 10% and sell (part of) their participation within a period of six months. However, according to the tax treaty concluded between Luxembourg and the UK, Luxembourg's right to tax capital gains realized in these circumstances would be excluded. This should not change in case of a potential hard Brexit. It is further not expected that the new tax treaty between Luxembourg and the UK (currently under negotiation) will change anything in this respect.

Anti-abuse legislation

In an EU context, anti-abuse legislation (anti-directive shopping rules, general anti-abuse rule, principal purpose test in tax treaties concluded between Luxembourg and other EU Member States, etc.) has to be applied in compliance with EU Law as interpreted by the Court of Justice of the European Union ("CJEU"). Thus, in accordance with established CJEU case law, a Luxembourg investment platform that is equipped with appropriate substance should be out of reach of foreign anti-abuse rules irrespective of whether or not the UK is a member of the EU.

Conclusion

The Brexit negotiations between the UK and the EU are currently locked in stalemate. While the UK representatives clearly rejected the withdrawal agreement as is, the EU does not seem to be willing to reopen negotiations on the terms of this agreement. However, if the UK and the EU fail to agree a withdrawal agreement, there would be no transition period after 29 March 2019 and EU laws would stop applying to the UK immediately. At this point in time, it is very difficult to anticipate what will happen in the coming months given the division of the political spectrum in the UK.

The developments in the UK are of particular interest to Luxembourg that is a hub for both UK inbound and UK outbound investments. In this article, the authors analysed the consequences of a potential hard Brexit on cross-border investments involving the UK. Overall, for a large part of these investments the impact of a hard Brexit should be limited, considering Luxembourg and UK tax law as it stands and the existing tax treaty. The potential impact of the new tax treaty that is currently under negotiation needs to be carefully monitored however.

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