Brexit – The Luxembourg tax angle

19 July 2016

In brief

The UK voters chose, on 23 June 2016, to exit from the EU ("Brexit"). How and when the exit will happen needs to be determined by the EU and the UK in the coming months. The impact Brexit will have on the UK and the EU member states can only be fully assessed after the negotiations have been finalised—which could take up to two years. One area that we know will be heavily impacted is taxation. However, the full effects will depend on the UK's status going forward (e.g. whether or not the UK is part of the EEA, what bilateral agreements are concluded, if the UK is a "third" country, etc.).

The following is a preliminary overview of possible impact Brexit may have on tax from a Luxembourg perspective.

In detail

EU Parent-Subsidiary Directive

Under current Luxembourg legislation, Luxembourg companies can distribute dividends to companies in the EU / EEA free of any withholding taxes. In the future, dividends from Luxembourg to its UK parent company may still be exempt from withholding tax based on domestic law, but with additional conditions or may be taxed at 5% under the double tax treaty concluded between the countries. In the reverse case where dividends are paid from a UK subsidiary to its Luxembourg parent company, such dividends can still be fully exempt in Luxembourg based on domestic laws, but again subject to more stringent conditions. There is also no withholding tax on dividends paid by a UK company according to UK domestic law.

EU Interest and Royalty Directive

While Luxembourg does not levy any withholding tax on interest and royalties based on domestic law, the UK law foresees a 20% withholding tax on interest and royalties, which could be reduced to zero based on the Directive. There is still a full exemption available under the double tax treaty with Luxembourg for interest, but for royalties a 5% withholding tax rate would still apply.

EU Merger Directive

Mergers between companies in Luxembourg and the UK can currently be achieved under certain conditions in a tax neutral way based on the Directive. This should, in principle, no longer be possible.

Anti Tax Avoidance Directive

While the UK should not be bound by this directive, it may have an impact on Luxembourg where cross-border transactions with the UK are concerned, to the extent a measure in the Directive only applies for transactions between member states, e.g. hybrid instruments. The Directive, however, may also extend the scope for certain measures to "third countries".

EU State-Aid

With the exit from the EU, the UK will no longer be subject to so-called “state-aid rules” as per article 107 of the treaty on the functioning of the EU. The recent assessments by the EU Commission of certain taxation practices in various member states and for several multinational groups as unlawful state-aid has become a concern for multinational groups. The state-aid rules are there to avoid distortion of competition among companies or industries within the EU by means of state subsidies, which may also include selective tax benefits.

EU Court of Justice

Significant changes in the UK tax legislation and practice have been introduced in the last couple of years based on decisions by the CJEU, particularly the Cadbury Schweppes case and the Marks & Spencer case, to name two important ones. In the Cadbury Schweppes case, the CJEU ruled that within the framework of freedom of establishment in the EU, controlled foreign company (CFC) legislation can only be applied to wholly artificial arrangements. In the Marks & Spencer case, it was decided that, again within the framework of freedom of establishment, that final tax losses incurred by EU subsidiaries should be deductible from the tax base of the UK parent company.

In the event that the UK again reinforces its CFC legislation after the exit, this may have an impact on how Luxembourg entities in the structures of UK-based groups should operate. The (foreign) loss utilisation rule has been less relevant in the past for Luxembourg subsidiaries or branches of UK groups.

US double tax treaties

When investing in the US, European companies can qualify, under certain conditions, for reduced withholding tax rates on payments from the US investments based on the respective double tax treaty with the US. One of the key provisions in the double tax treaties that allows such benefits is the so-called “derivative benefits provision” as part of the limitation of benefits (LOB) articles. While there is variation from one treaty to another, an EU company can qualify for the treaty benefits if the two following conditions are met:

1. Seven or fewer “equivalent beneficiaries” own at least 95% of the company claiming the benefits, and

2. Less than 50% of the company’s gross income is paid/accrued to persons who are not “equivalent beneficiaries” in the form of tax deductible payments.

The definition of “equivalent beneficiary” is, therefore, a key element in that analysis. Among other conditions, a person may be an equivalent beneficiary if the person is resident in the EU or EEA (for some treaties, not including Luxembourg).

As a consequences, UK groups investing e.g. via a Luxembourg structure into the US may no longer get the benefits under the US-Luxembourg treaty in the current version.

Other income tax impacts

There are other areas in the Luxembourg income tax law, which were established based on EU legislation, where certain benefits apply, particularly in relation to or involving EU/EEA member states (e.g. the migration of companies or branches, the application of a fiscal unity etc.). However, the Luxembourg income tax law usually goes beyond EU legislation and extends specific benefits to “third countries” under certain conditions.

VAT

General Implications

From the date of the actual exit, EU Law will cease to apply, which basically means the removal of the EU VAT Directive, Regulations, general principles of EU Law and, in some cases, EU case law. The UK is likely to retain a similar VAT system given the importance of the VAT receipts in the total tax revenue. However, it will be free to amend it according to its own political and fiscal agenda. For example, the scope of VAT exemptions could be reviewed, as well as the structure of VAT rates.

The definitions of "place of business" and "fixed establishment" might change in the UK (as Regulation 282/2011 will no longer be applicable in the UK) and may not necessarily remain in line with EU law. This could lead to potential double taxation issues for EU businesses which have presence in the UK, and vice versa.

The place of supply rules in the UK might conflict with the place of supply rules in the EU, which could also lead to potential double taxation issues and obligations for EU businesses to register for VAT in the UK, in particular, if the reverse-charge rules no longer apply or apply differently.

The taxation principles applicable to services between head-offices and branches might change with potential consequence for EU businesses with a branch or their head office in the UK. VAT grouping rules in the UK might be reviewed and it is uncertain whether the "Skandia principle" will still apply considering that the UK did not fully agree with the conclusions of that case.

The UK VAT refund process for EU suppliers that will be put in place (if any) is uncertain (former 8th directive refund claims will no longer be available). EU businesses will need to protect against any unfavourable changes and seek the recovery of their UK VAT receivables as soon as possible. This applies equally to UK business having VAT credits in EU countries.
EU businesses will need to update their systems/VAT coding/legal agreements/pricing with respect to supplies to UK customers. The VAT treatment and compliance obligations regarding supplies to UK customers will have to be reviewed, as well.

Data storage (accounting/invoices etc.) for Luxembourg-established businesses might no longer be possible in the UK.

Implications for the Financial Sector

EU businesses should become entitled to input VAT recovery because of their exempt financial and insurance services to UK customers, as they currently are for such services to non-EU customers. The recoverability of input tax for those businesses will be improved.

The scope of VAT exemptions in the UK might change, in particular with respect to banking, insurance and fund management services provided to/by Luxembourg-based businesses.

The status of qualifying funds for the purpose of the VAT exemption might also change in the UK.

The scope of services connected with immovable property might change in the UK and it is unsure as to whether the extended reverse-charge currently applicable in the UK will remain. This could mean that more businesses could become liable to register for VAT in the UK. It is also unclear as to how the Luxembourg tax authorities will apply the "Luxembourg test" for Luxembourg property companies that hold immovable property in the UK.

Services provided by UK companies to non VAT registered companies in Luxembourg (like pure holding companies) may now be charged free of VAT.

Implications for operational and industrial companies

UK-Luxembourg movements of goods will qualify as importations and exportations which might attract VAT and Customs duty. While European Sales Listings and Intrastat declarations will no longer be required with respect to UK-Luxembourg supplies of goods, formalities linked to Customs requirements will create a significant additional burden.

The triangulation simplification provided for in the VAT directive will no longer be available for the middleman where goods are shipped to the UK.

UK telecoms, broadcasting and electronic service providers will be required to register for VAT in one Member State to be able account for VAT on supplies to EU individuals under the MOSS (Mini One Stop Shop). Luxembourg-based telecoms, broadcasting and electronic service providers will no longer be able to declare supplies to UK-based individuals in their MOSS returns and might be liable to register for VAT in the UK. Complications might also arise in relation to supplies made via intermediaries (B2B2C supplies) where the intermediary is located in the UK, in particular, since Article 9a of Regulation 1042/2013 will no longer be applicable in the UK. The assumption that the intermediary is providing the B2C service might no longer apply which could lead to potential VAT registration obligations in the UK for the provider.

Use and Enjoyment rules both for telecoms, broadcasting and electronic services as well as transport of goods and related services should apply in relation to supplies in the UK (i.e. be outside the scope of VAT). However, they might become subject to VAT in the UK.

The distance selling regime will no longer be available for sales by EU businesses to UK consumers and UK suppliers will no longer be able to make use of the regime for their sales to EU clients. It is not clear what the UK requirements will be for EU businesses selling goods to UK individuals.

Customs

The impact of the possible changes in the customs duties realm will be felt throughout the supply chain for goods. Customs duties are currently governed by EU law, not UK law. The UK will need to introduce its own legislation which could more or less vary from the existing one. The changes may not only affect the duty rates, but also the conditions for operating duty reliefs and general customs procedures.

As far as trade between the UK and the EU is concerned, the UK could seek to negotiate a Free Trade Agreement (FTA) so as to maintain the status quo or at least to minimise the impacts of the exit. It is, of course, impossible to predict now the final outcome of those negotiations.

People implications

Personal taxation

No immediate personal tax implications are expected as both the UK and Luxembourg personal income tax systems are completely separate and Brexit does not impact the tax treaty between the two countries. However, as the EU non-discrimination rules would no longer apply for the UK, there is nothing preventing the UK from amending any part of its tax system. For example, the UK could prevent non-UK tax resident individuals accessing certain UK tax deductions.

Social security and pensions

Exit from the EU may mean that the EU Regulations relating to social security coverage and benefits would no longer apply. If this happens, internationally mobile employees working on a temporary basis in the UK (or, in the reverse situation, UK employees working in Luxembourg) or with multi-state activities would no longer be able to rely on EU social security rules and coverage. This may trigger:

- Increased social security costs and/or lack of social security coverage;
- Fragmentation of socials security costs and benefits; and
- Increased social security costs for employers.

Employees who have been affiliated with the UK social security system for (part of) their professional career may have their legal pension rights impacted (e.g. if the years during which contributions have been made to a foreign social security regime are not recognised by the other state).

Immigration

Brexit could mean an alteration of the freedom of movement principles as they apply today between the UK and Luxembourg. This would impact employees' mobility between the UK and the EU and potentially result in a heavier administrative burden for employees/employers in connection with work visas.

What happens next?

For organisations with a business footprint in the UK, it is essential to closely monitor the Brexit negotiation process as it unfolds. There will be a variety of impacts, and ensuring operational flexibility and readiness for the changes ahead to manage the potential tax impact will be crucial.

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