http://blogs.pwc.de/german-tax-and-legal-news/

Tax & Legal News

Statutes
Cases
Decrees

Special Edition, July 2016

pwc

Special Brexit Edition

Brexit: The United Kingdom of England, Wales, Scotland and Northern Ireland is leaving the European Union: A first analysis of the potential tax implications

So much is clear: on 23 June 2016 the majority of British people voted to leave the EU. No date for "Brexit" can, however, be anticipated yet. Before formal negotiations can begin, the UK must notify the European Council of its intention to withdraw under Article 50 Paragraph 2 of the Lisbon Treaty. Thereafter Article 50 Paragraph 2 provides for a period of up to two years to negotiate a withdrawal agreement; the two-year period may be extended if no agreement is reached, provided the European Council, in agreement with the withdrawing Member State, unanimously agrees to extend the period. Currently, a date for the formal notification can only be a matter for conjecture. Nevertheless, businesses should be aware now of the potential tax implications of Brexit - praemonitus, praemunitus – forewarned is forearmed.

Here, a brief summary:

Membership of the European Economic Area or Third Country?

Whether or not the UK will become a member of the European Economic Area (EEA) after its withdrawal from the EU is still a matter of speculation. From a German tax point of view, an EEA membership after withdrawal is critical, as the majority of tax provisions relating to EU membership may also be extended to EEA members. Thus, "the basic EEA Freedoms" – except for capital movement with third countries – offer almost the same level of protection as the basic freedoms of the EU. In contrast, for third countries the level of protection will depend on the terms of the relevant agreements. An example of this is the agreement for the free of movement of people with Switzerland. It will be necessary to wait and watch exactly how far the British extract themselves from the EU and whether a certain level of protection will be maintained through either an EEA membership or bi-lateral or multi-lateral agreements.

Non-application of European primary, secondary legislation and state aid rules

Protection under the directives in relation to direct taxes will cease upon Brexit, as these are only applicable within the EU. This applies, for example to:

- The Parent/Subsidiary Directive (implemented into German law through Section 43b of the Income Tax Act ("ITA")); currently German companies can benefit from a withholding tax exemption on profit distributions made to a British parent company and can make distributions without withholding any tax. In future withholding tax of 5% may become payable, which, due to the exemption in the UK, would lead to a definite additional burden for the business. Attention must be paid to existing exemption certificates and minimum holding periods.

- The Interest and Royalties Directive (implemented into German law through Section 50g ITA); currently royalty payments emanating from Germany to the UK will generally not be subject to withholding tax under the terms of Section 50g ITA. The Tax Treaty between Germany and the UK also provides for a withholding tax exemption, so that, in contrast to profit distributions, no additional withholding tax risk should arise.

- The Mergers Directive (implemented into German law through the Reorganisation Taxes Act); within the EU, it is possible under certain conditions to carry out a reorganisation, such as a merger, a de-merger or a spin-off, on a tax neutral basis. In many cases, one of the conditions is that the entities involved are formed according to the legislation of an EU Member State and they have their registered office and place of management in an EU Member State. Upon the UK's withdrawal from the EU, reorganisations involving the UK will no longer fall within the scope of the Reorganisations Taxes Act, unless an exception to the territorial scope should apply (see below).

- EU Mutual Assistance Directive and the planned Anti-Avoidance Directive – the so-called Anti-BEPS Directive

Furthermore with a withdrawal from the EU, the UK would no longer be subject to the state aid prohibitions according to Article 107 of the Treaty on the European Union and the Treaty on the Functioning of the European Union.

Exceptions to CFC Rules

The German Foreign Taxes Act (FTA), Section 8, regulates the so-called CFC rules. According to the relevant rules where German resident individuals and legal persons hold a controlling influence (e.g a shareholding of > 50%) in a foreign intermediary company, which is resident in a low-tax country (with an income tax rate of less than 25%) and which company also realises passive income within the meaning of Section 8 FTA, that passive income will be attributed to the German resident shareholders. In principle, the add-back of passive income may only be avoided, if

- The foreign company realises active income according to the Section 8(1) FTA catalogue; or
- The foreign company is resident in the EU or EEA and has sufficient substance.

Nominally the UK could be regarded as a low-tax country, as its rate of corporation tax is less than 25%.This could mean that the passive income of a British subsidiary could be subject to the CFC add-back in Germany. Previously, however, it was possible to rely on the exceptions mentioned above. Full protection under these exceptions does not apply to third countries. Thus the so-called "Motive Test" under Section 8(2) FTA (second bullet above) requires that the foreign intermediary company has its registered office or place of management in an EU/EEA state. If a country, where the registered office or place of management is located, withdraws from membership, the Motive Test may no longer be applied and the only way to avoid the CFC add-back would be through applying the "Activity Test" under Section 8 (a) FTA (first bullet above). Nonetheless, we should also bear in mind the development of case law on the question as to whether the CFC add-back constitutes an infringement of the right to free movement of capital, so that the Motive Test should also be applicable to third countries.

Deferral of expatriation tax

Where an individual with a shareholding within the meaning of Section 17 ITA relocates to an EU/EEA state, then the expatriate tax will be deferred - interest free and without having to provide any security. The deferral will, however, be withdrawn, where residency within the EU/EEA ceases due to the individual giving up his residence. Since in the case of the withdrawal of a Member State from the EU, the individual himself would not be actively giving up his residence, it should not really result in a revocation of the deferral. Nevertheless there is still a risk of negative tax implications. The reason for this is that, under the relevant provisions, after his relocation, the individual must be subject to unlimited taxation in one of “these” States. It is not clear whether this condition specifically relates to the circumstances existing at the date on which the individual relocated or whether the relevant conditions must be met for a continual period; in the latter case the withdrawal of a Member State from the EU may lead to a revocation of the deferral.

Proof of exoneration in the case of foreign family foundations

According to Section 15 (6) FTA, family foundations, which have their registered office or place of management in the EU or EEA, may – in order to avoid a taxable fictional add-back under Section 15(1) FTA – show, that the persons named in Sub-sections 2 and 3 have been both legally and in fact divested of their title in the foundation property and that a sufficient exchange of information is assured either under the terms of the EU Mutual Assistance Directive or a similar instrument. This option is no longer available where the registered office or place of management of the foundation leaves the EU/EEA. It may be open to discussion whether this restriction to the physical application of the rule is compatible with the right to free movement of capital, in which case it should also be possible to prevent the taxation of fictional add-backs in the case of third countries.

Leaving the tax net and deferrals

Where an asset of a taxpayer is treated as withdrawn (i.e. withdrawn for non-business purposes) after having been allocated to a branch of the same taxpayer located in another Member State, the taxpayer may, subject to the conditions set out in Section 4g ITA, create a balancing provision in an amount of the difference between the book value and the fair market value. This balancing provision is generally to be released – increasing profits - in the year of creation and in the four subsequent financial years at a rate of 1/5 per annum. However, where the asset in question is removed from the tax net of the EU, it is to be released in full. Potentially, this situation may arise when the UK withdraws from the EU. This situation would not change if the UK remained a member of the EEA. In this regard it should be noted that the taxpayer is obliged to inform the relevant tax authorities without delay of the removal of the asset from the EU.

The same applies to cross-border transfers of businesses, noting here, however, that Section 36(5) ITA also applies to EEA cases. The result of this is that, where a business is “re-relocated” on to a third country, the balance of the deferred tax will become payable within one month. The rule in Section 36(5) ITA – in contrast to Section 4g ITA – applies to the act of further relocation, so that it should be arguable that the UK’S withdrawal from the EU cannot trigger the provision.

It is also an open question, whether a provision can trigger tax implications, where the taxpayer himself has taken no action.

Trade Tax participation exemption

Under certain conditions, foreign dividends may be deducted from the trade tax base under Section 9 No. 7 Trade Tax Act (TTA).The provision states that the deduction is generally only available where the income is sourced from certain activities; however, the caveat does not apply where the distributing company is an EU company. Where a Member State withdraws from the EU, the Activity Test must be applied to the dividend income arising from this state. If sufficient evidence is not available, the trade tax participation exemption is not applicable, unless a deduction is available under another provision.

CFC taxation and trade tax

The first draft of the "Act to implement the amendments to the EU Mutual Assistance Directive and to implement further measures to combat the reduction of profits and profit shifting" proscribes a fiction that passive low-taxed branch income should be treated as though it accrued to an (already existing) domestic branch. The inclusion in the trade tax base may be avoided, however, where the Motive Test under Section 8(2) FTA is passed. The withdrawal from the EU/EEA would exclude the proof of substance for trade tax purposes.

Transfer of registered office to a third country

According to Section 12(3) of the Corporation Tax Act (CTA) a company is treated as liquidated if, through the transfer its registered office or its place of management, it is no longer an unlimited taxpayer in an EU/EEA State. The provision requires action on the part of the taxpayer, so that it should not apply where the company becomes resident in third country through its withdrawal from the EU. Existing structures should, therefore, not be affected, although post-Brexit structures would be.

Registered office requirements for controlled enterprises ("Organgesellschaft")

Section 14 (1) CTA generally allows a company with its place of management in Germany and its registered office in an EU/EEA State to be a controlled enterprise ("Organgesellschaft") in a tax consolidation group.

The status of an entity as an Organgesellschaft for these purposes are, therefore, at risk for controlled enterprises with a registered office in the UK.

Repayments of capital contributions by EU companies.

Section 27(8) CTA regulates repayments of capital contributions and possibly also the repayment of share capital by EU-resident companies. The German Federal Ministry of Finance takes the view that the provision also applies to EEA cases. When the UK withdraws from the EU, it is not clear what the treatment of UK resident subsidiaries will be; in particular, whether the tax neutrality of such repayments could be retained. Accordingly, we will need to wait and see, whether case law continues to follow the line that in cases involving third countries, the treatment of the transaction under the foreign company law is relevant. If the foreign law in question treats the transaction as a return of capital, it may be assumed that, subject to certain conditions, it will be treated as a tax neutral repayment in Germany.

Physical scope of application of the Reorganisations Taxes Act

The Reorganisations Taxes Act (RTA) applies, in principle, only to those reorganisations, which involve reorganising/transferring/receiving entities, which have been established according to the legal provisions of an EU/EEA Member State and which have their registered office and place of management in the territory of one these states. These conditions must apply at the time of the reorganisation, so that reorganisations which have already been completed should generally not be affected by a withdrawal of the UK from the EU/EEA. For such future transactions it will be necessary to wait and see whether the UK becomes/remains a member of the EEA. If this were the case it should be also possible in future to apply the RTA. It may be noted, however, that in certain circumstances, the RTA may be applied in cases, in which residents of third countries are involved. Each type of reorganisation should therefore be examined in detail.

Alternative triggering events according to the Reorganisations Taxes Act

Where new shares, received in a transferee/receiving company by the contributing party in consideration of a contribution within the meaning of Section 20 RTA, are transferred within a 7 year period following the date of the contribution, the RTA triggers a so-called “Contribution Gain I” retroactively. This also applies where the residency conditions according to Section 1(4) RTA are no longer met by the contributor or the transferee entity. This would be an issue, where the UK left the EU without remaining in the EEA, so that, in certain circumstances, a “Contribution Gain I” may also be triggered in the case of completed reorganisations.

Treaty Overrides within the Mergers Directive

Following a Brexit, the Mergers Directive will no longer be applicable; this will have a direct impact on Section 13 (2) No.2 RTA (Mergers) and Section 21(2) No.2 RTA (Exchange of Shares). Where the Mergers Directive applies to transactions carried out under the above-mentioned sections, the taxpayer may apply to continue with book values. Where a gain arises through the subsequent realisation of the hidden reserves, Germany can tax the gain without regard to the tax treaty. It should be noted here, that this situation will not change even if the UK remains in the EEA, as the Directives only apply to EU Member States.

Relief for groups in the Real Estate Transfer Act

In order to make internal group reorganisations simpler, the German legislator has introduced rules, according to which “transfers” of real property occurring during an internal group restructuring may benefit from a real estate transfer tax (RETT) exemption. This relief for groups according to Section 6a RETT Act may also be applied to group restructurings, which are carried out under the legislation of an EU/EEA Member State. If the UK withdraws from the EU/EEA, the relief will no longer be available.

As soon as the UK loses its status as an EU Member State various business law problems may arise which have direct tax implications:

Relocation of businesses

If an entity relocates its place of effective management from the EU/EEA Member State, in which it was established, into another EU/EEA Member State, the latter EU/EEA Member State is obliged to recognise the newly arrived entity because of the right to freedom of establishment. This recognition obligation applies to EU and EEA Member States (and applies to third countries, where there is a relevant bi-lateral treaty). Without a membership of the EU/EEA and without a bi-lateral treaty with the UK, Germany would apply to so-called “real seat theory”, according to which the legal position of an entity will be determined in line with the legislation of the place of effective management. The same applies to many other member States, which pursue a “real seat theory” in their relations to third countries. For British entities (especially Limited Companies and Limited Liability Partnerships) with their place of effective management in Germany, a Brexit could therefore give rise to businessl law and tax law issues starting from an obligatory change of form to a realisation of hidden reserves.

The European Company (SE)

The registered office of a European company (Societas Europaea, SE) must be located in the EU Member State, in which its head office is located. As a result, after a Brexit, entities with the legal form of an SE could by implication no longer be established in or continue to exist in the UK.

Do you have any questions?

Then please contact your regular PwC-Advisor or send us a mail to the following e-mail address: PwC_Mandanteninformation_E@de.pwc.com.

Please note the preceding articles are merely intended to provide a general overview of the relevant issue. If you would like to discuss a specific issue raised by the article, please contact the PwC office working with you. We have also provided you with source details for further reading. Parts of the publication/the information provided may only be reproduced or copied with the written permission of the editor. Any opinions expressed in the foregoing articles reflect the views of the individual authors.

From PwC

Breaking news

If you would like to follow the latest news on German tax as it breaks, please visit our Tax& Legal News site at
http://tax-news.pwc.de/german-tax-and-legal-news

English language blogs in which you may be interested are CITT (Customer and Investor Tax Transparency) News http://blogs.pwc.de/citt/
Establishment of Banks http://blogs.pwc.de/establishment-of-banks/

Editor's Office

Emma Moesle

PricewaterhouseCoopers AG WPG
Friedrich-List-Straße 20
45128 Essen

Tel.: +49 201 438-1975
emma.moesle@de.pwc.com

Subscribe or unsubscribe

You may take out a new subscription to the newsletter with a simple e-mail to SUBSCRIBE_PwC_Mandanteninformation_E@de.pwc.com. Existing subscriptions may be cancelled at UNSUBSCRIBE_PwC_Mandanteninformation_E@de.pwc.com.