BREXIT
A NEW TAX OPERATING MODEL?

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Although the impact of Brexit on fund performance and distribution has attracted the most attention, its impact on asset managers' corporate structures also needs to be assessed. The loss of passporting rights could force some UK asset managers to restructure their operations in the EU. Legal and regulatory issues will be the key drivers of change, but tax considerations are important too.

Brexit restructuring

The UK's departure from the EU could have a significant impact on how UK-based asset managers operate within the single market. The EU's UCITS, MiFID and AIFMD rules currently allow UK regulated companies to passport across the EU. UK-based asset managers may currently rely on these passporting rights in order to:

- Distribute products in the EU, for example through EU branches; and
- Manage EU-domiciled funds, or segregated portfolios, directly from the UK.

The precise impact of Brexit on these arrangements is currently unclear, and is likely to affect different managers in different ways. It will depend in particular on the types of product which are managed, the manager's client base, and how the various EU directives are relied upon.

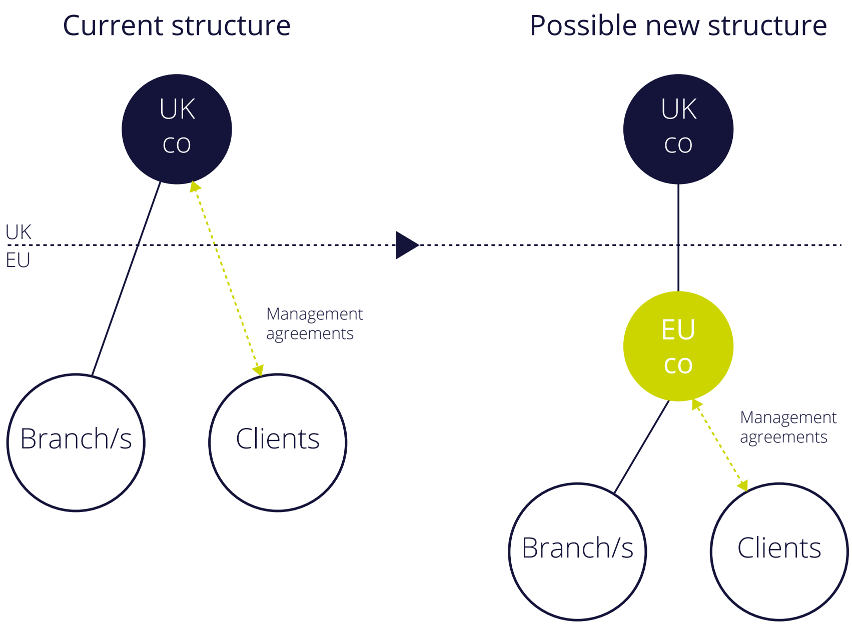
However, it is likely that some will need to make important structural changes to continue operating across the EU. Such changes are likely to include undertaking more activity through companies established in the EU, which we refer to as "EUco" in this article.

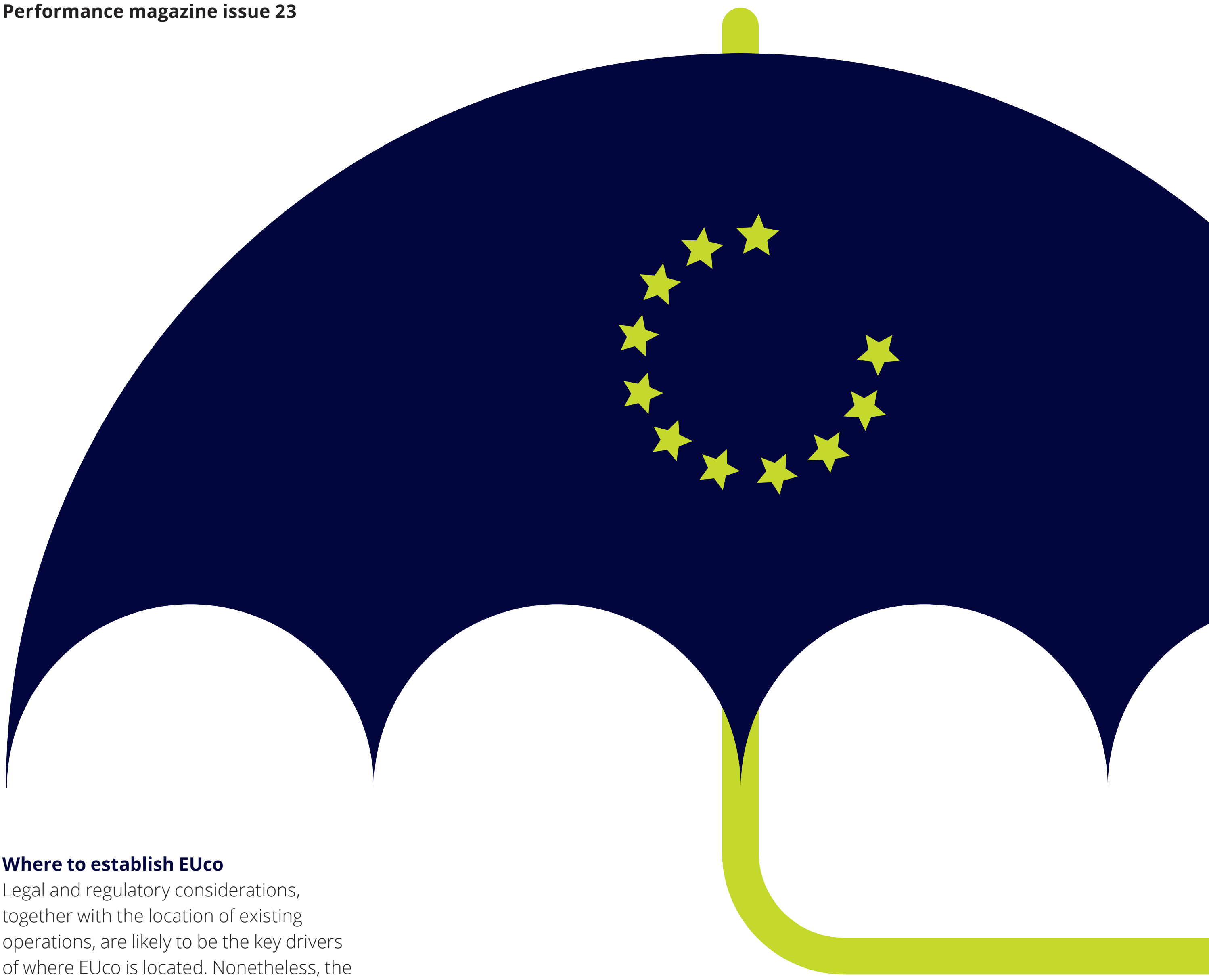
The transfer of distribution and portfolio management activity from the UK to EUco could have a number of significant tax consequences.

Key questions which managers need to consider include:

- Should tax have a bearing on where EUco is located?
- Will the transfer of branches or management agreements to EUco give rise to taxable disposals, or VATable supplies? If so, are reliefs available?
- What are the ongoing tax consequences of operating EUco?

In this article we discuss some of the considerations which are pertinent to these questions.





Where to establish EUco

Legal and regulatory considerations, together with the location of existing operations, are likely to be the key drivers of where EUco is located. Nonetheless, the tax regime which applies to EUco will have an impact which should be assessed.

Corporate tax regimes

An obvious question is whether the activity which is transferred to EUco will be taxed at a different rate to the UK's. The UK corporate tax rate is currently 19%, and will fall to 17% by 2020.

These are lower than the rates in many of the UK's neighbours in continental Europe. Will performing distribution and portfolio management through EUco lead to higher corporate tax liabilities?

This is likely to depend on a few factors, including:

1. How much activity is transferred to EUco, and what profit the transferred activity generates. This in turn is likely to depend upon what EUco's regulator will require in terms of substance and local presence (i.e. people "on the ground"), and the transfer pricing policies which are applied to EUco.

2. The treatment of any branches transferred to EUco. If EUco is in a jurisdiction which exempts branch profits from tax, those branch profits will only be taxed in the branch jurisdictions. There will be no additional tax on branch profits in EUco's jurisdiction, and EUco will only pay tax on its "head office" profits.

3. Local tax rules, including what expenses can be deducted from taxable income and what tax incentives and allowances are available.

Of course, if EUco is based in a jurisdiction with a lower tax rate than the UK's, like the Republic of Ireland, the new structure could generate tax benefits. However, anti-avoidance rules would need to be looked at, like the UK's controlled foreign companies and diverted profits tax rules.

Repatriating profits

Currently, the EU parent & subsidiary directive can prevent withholding tax from being applied to dividends paid from an EU subsidiary to its EU parent. So a dividend received by a UK company from an EU subsidiary should currently be free from withholding tax.

Once the UK leaves the EU, this withholding tax exemption may no longer apply, and UK companies may need to look to the UK's tax treaties for withholding tax

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reliefs. Not all tax treaties provide a full exemption from dividend withholding. For example, the UK-Germany tax treaty reduces the withholding tax rate to 5%, not nil. Therefore, absent a rule change or a renegotiation of the tax treaty, transferring activity to a German EUco could lead to withholding tax leakage on dividends.

VAT rules

As with any structure which involves the cross-border provisions of services, VAT should be looked at carefully. This is particularly so where EUco will be operating through branches. At the moment, charges between overseas branches and their head office are normally VAT-free. However, in response to the CJEU's Skandia judgement, many EU jurisdictions are changing their rules to impose VAT on certain transactions between a head office and its branches.

Whether (and how) the judgement in Skandia will be adopted in EUco's jurisdiction could have a significant impact on the VAT treatment of any new structure.

Different jurisdictions also have different rules on how VAT exemptions are applied, when entities can form a "group" whose members do not need to charge VAT to one another, and the way in which input VAT can be recovered. They also have different rates of VAT. All of these will have an impact on VAT costs in a post-Brexit structure involving EUco.

It is also worth remembering that VAT rules are governed by EU legislation. This means that, post-Brexit, the VAT landscape will change, adding an element of uncertainty to any assessment of how VAT will impact business operations in the future.

Transferring operations to EUco

Having decided where to establish EUco, the next key decision relates to how operations should be transferred to it.

Tax is absolutely key to this decision making. This is because the transfer of assets from one company to another is normally a market value disposal for tax purposes, and possibly a supply for VAT purposes too.

Where the assets are valuable, there is the risk of creating significant tax liabilities.

Fortunately, reliefs can mitigate these liabilities in many situations. However, they often require complex conditions to be met and do not apply to every situation.

Transferring branches from the UK to EUco

The transfer of branches from a UK company to EUco can be complex, because two layers of tax need to be considered: one in the branch jurisdictions, and a second in the UK.

In the branch jurisdictions, reliefs may allow the branch assets to transfer to EUco neutrally, from a local corporate tax and VAT perspective. However, this will be subject to satisfying the local requirements. It may also be necessary, or advisable, to obtain a ruling from the local tax authority.

Interestingly, in some EU jurisdictions, the reliefs permitting tax neutral transfers could potentially be clawed back if the transferor ceases to be an EU company within a defined period after the transfer takes place. This means that, when the UK leaves the EU, taxable gains could potentially crystallise on previously-transferred branch assets.

In the UK, companies can elect to treat overseas branch profits as exempt from UK corporation tax. Where this election has been made, the transfer of branch assets to EUco should not be a taxable disposal. Whilst in principle this should make things simple, there are a few complexities to watch out for, including where an exempt branch has made tax losses and where there have previously been transfers of assets between the branch and its head office.

If a branch profit election has not been made, the transfer of branch assets will be a disposal for UK tax purposes, although any UK tax liability can be reduced by tax suffered in the branch territory on the same gain. However, if a relief applies in the branch territory, there may be no branch tax to "credit" against the UK liability. In this case, UK tax creates a cost.

Helpfully, there are special reliefs which can defer or eliminate the UK tax which would otherwise arise on the transfer of branch assets to EUco. These reliefs are subject to a number of detailed conditions.

1 A representative office is an operation which does not create a taxable presence, or "permanent establishment" in its local jurisdiction

One of the reliefs is also subject to a clearance procedure.

Some UK managers operate the in EU through representative offices rather than branches. Applying the rules and reliefs to the transfer of representative offices can cause difficulties which need to be worked through.

Transferring management agreements from the UK to EUco

The transfer of management agreements to EUco can also be problematic. A cross-border transfer of a UK asset, on the face of things, is a market value disposal by the UK management company, and potentially a VATable supply too.

Where management agreements are valuable, some managers may consider terminating the existing agreements and putting in place new ones with EUco. If the existing agreements contain terms which permit such a termination, there is an argument that there has been no disposal of value, or supply.

However, this approach does come with risk. The clients could choose not to appoint EUco, or could use the termination as an opportunity to renegotiate terms. It would also be necessary to consider whether the UK management company had played a role in EUco's appointment, which under transfer pricing principles should attract a reward.

Operating EUco

Once EUco has been established and activity has been transferred to it, the focus will be on operating it as efficiently as possible. Ideally, these operational considerations should have been assessed as part of the jurisdiction selection work. As noted previously, key issues are likely to include VAT leakage arising on cross-border charges, exposure to different rates of corporate tax, and the risk of withholding tax on profit repatriation.

Where staff need to be relocated or will be travelling between the UK and EUco's jurisdiction, managers will need to have policies and frameworks in place to meet business requirements and also comply with the applicable tax, social security, and immigration rules.

Managers will also need to consider strategies for rewarding and incentivising EUco's staff. They will need to understand the local regulatory requirements on remuneration, how to structure local pension arrangements, as well as legal issues pertinent to participation in global incentive plans, the transfer of employee data, as well as employment rights.

The more practical day-to-day consequences of operating EUco should not be overlooked either, for example tax registrations, filings and other compliance obligations.

To the point:

- Brexit may require UK asset managers which currently rely on passporting to move some operations to other EU jurisdictions.
- Tax rates and rules vary across EU jurisdictions, which could influence the decision on where operations are moved to.
- The transfer of business from a UK company to a company elsewhere in the EU could be a market value disposal for tax purposes, and a VATable supply. Reliefs can apply, but need to be looked at carefully and are not always available.
- Tax will need to be considered for a new, post-Brexit operating model.

Applying the rules and reliefs to the transfer of representative offices can cause difficulties which need to be worked through.