DOING BUSINESS POST-BREXIT: WHAT TO EXPECT IN THE UNITED KINGDOM

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BREXIT – A BRIEF REVISIT

The U.K. is firmly on course to leave the E.U., with a target date of March 29, 2019. Several U.K. and E.U. figures are backing the idea of a "transition" period, of around two years thereafter, to facilitate smooth implementation of the final Brexit deal and minimize disruption to businesses, tourists, and the like.

The terms "soft" and "hard" Brexit are often used in the debate over the terms of the departure from the E.U. While there is no strict definition of either, they refer to the closeness of the U.K.'s relationship with the E.U. post-Brexit. At one extreme, "hard" Brexit could involve the U.K. refusing to compromise on issues like the free movement of people, even if it meant leaving the single market. At the other end of the scale, a "soft" Brexit might follow a path similar to that of Norway, which is a member of the single market and must accept the free movement of people.

Politics aside, E.U. and U.K. negotiators have taken steps in recent months toward reaching agreements in principal regarding several contentious issues.

WHERE IS THE PROCESS TODAY?

After a difficult first 18 months since the U.K.'s decision to leave, three important "divorce" issues have been settled or addressed in a deal signed in December 2017.

- How much the U.K. owes the E.U. (the "Exit Payment")?
- What happens to the Northern Ireland border?
- What happens to U.K. citizens living elsewhere in the E.U. and E.U. citizens living in the U.K.?

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The Exit Payment

In a joint agreement between the U.K. Treasury and the E.U.'s chief Brexit negotiator Michel Barnier that was reached in December 2017, the U.K. government confirmed that it is committed to paying a "divorce bill" totaling between £35 billion and £39 billion (approximately $47 billion to $53 billion). This will cover Britain's obligations to the E.U. "outstanding at December 31, 2020."

The final amount is unlikely to be known for many years, as it depends on items such as future pensions and development projects. Government backbenchers have sought assurances that the payment will be contingent upon the agreement of a suitable outcome on future trade negotiations. However, Chancellor of the Exchequer Phillip Hammond has intimated that Britain will honor its commitment irrespective of any trade deal with the E.U. Consequently, it is anticipated that amounts due

will be payable on the dates that would have applied if the U.K. remained an E.U. Member State.

Nonetheless, the U.K. government has commissioned the National Audit Office to investigate the basis of the divorce bill, with instructions to pay particular attention to the assumptions and methodologies used to calculate the amount due.

Northern Ireland

Another stumbling block has been the fate of the border between Northern Ireland, which is part of the U.K., and the independent Republic of Ireland. Post-Brexit, it will be the only land border between the U.K. and the E.U.[1] This is a point not resolved but is more aptly described as "shelved for now."

With the U.K. as a member of the E.U., both the Republic of Ireland and Northern Ireland belong to the E.U. single market and customs union. They share the same regulations and standards, allowing for a soft or invisible border between the two jurisdictions. Britain's exit from the E.U. risks a return to a hard border that will be policed, unless both sides retain their present positions in key areas including food, animal welfare, prescription drugs, and product safety.

Early drafts of the agreement between the U.K. and the E.U. called for "no divergence" from E.U. rules that support north-south cooperation. However, this was later changed to "continued alignment," a formulation that appears to allow for subtle divergences.

The new terminology raised questions about who would oversee the border and how disputes might be resolved. It was also too far a step towards a hard border for soft border proponents in the D.U.P. (the Democratic Unionist Party of Northern Ireland), who are currently propping up Theresa May's minority government. This gives the D.U.P. an effective veto on Brexit matters.

Neither the Republic nor Northern Ireland wants a hard border. Trade and other links between the two jurisdictions are extremely close.

The British government has two stated ambitions which appear contradictory – leaving the E.U. single market and customs union while having no hard border.

For now, the question of the north-south border remains tenuous. Non-U.K. businesses may, on the optimistic side, view the Republic as the easiest post-Brexit trade portal into the U.K., if indeed there is some form of a soft border. Outside the Republic of Ireland, the E.U. is likely to have a different view of how that border should look.

Citizens' Rights

The December deal guarantees reciprocal protected rights, post-Brexit, to the three million E.U. citizens currently living in the U.K. and to the more than one million U.K. nationals living in the E.U. A joint document issued by the E.U. and the U.K. states that both U.K. nationals and E.U. citizens can continue "to live, work and study as they currently do under the same conditions as under EU law." The document also

[1] The border between Gibraltar and Spain has some of the same characteristics but Gibraltar is not part of the U.K. per se.

re-affirms free rights of movement until March 29, 2019, or the actual date on which the U.K. leaves the E.U.

Any E.U. citizen who is in the U.K. on Brexit Day will have the right to remain in the U.K., even if he or she arrives in the U.K. only one day before. Those not yet granted permanent residence in the U.K. will have their rights protected, so they can still acquire permanent residence after Brexit Day. The deal also includes re-unification rights for relatives of E.U. citizens not presently living in the U.K. These rights extend to future spouses or partners of E.U. citizens.

E.U. citizens living in the U.K. will have their rights enshrined in U.K. law and enforced by British courts. The process for giving E.U. citizens residency rights in the U.K. will fall under a new procedure known as settled status. The European Court of Justice will also have jurisdiction over these rights for eight years after Brexit Day. E.U. citizens will enjoy equal access to social security, healthcare, education, and employment. However, they could lose their residence rights if they remain outside the U.K. for five years or more.

U.K. citizens living elsewhere in the E.U. before Brexit Day will have the right to remain in their E.U. Member State of residence. They will be entitled to equal treatment regarding social security, healthcare, employment, and education. However, their freedom of movement will be limited as they will not be able to freely relocate to another E.U. Member State without first applying for a passport in their E.U. country of residence.

Certain rights of U.K. nationals after Brexit Day are currently unclear. These include the absolute rights to move to another E.U. country, work cross-border in the E.U., and receive free emergency medical treatment. Decisions on these items have been deferred to the second round of negotiations.

WHAT HAPPENS NOW?

Unpicking 43 years of treaties and agreements covering thousands of different subjects was never going to be a straightforward task. It has not been done before on this scale, and negotiators will be making the rules as they go along. The post-Brexit trade deal is likely to be the most complex part of the negotiation because it will require the unanimous approval of more than 30 national and regional parliaments across Europe, some of whom may want to hold referendums.

It is worth citing the C.E.T.A. (Comprehensive Economic and Trade Agreement) experience here. This treaty between Canada and the E.U. took seven years to conclude and nearly fell apart with the finish line in sight when the regional parliament of the Belgian province of Wallonia demanded a concession before giving their eventual consent. In the case of C.E.T.A., two areas of local concern jeopardized the approval process. These were use of arbitration panels rather than courts and concern that the treaty could be used as a backdoor entry to the E.U. for U.S. farmers and U.S. farm goods. The former was deleted from the treaty and the latter was addressed by the adoption of stringent standards for Canadian products to prevent indirect competition from the U.S. This illustrates the tenuous and fragile nature of negotiating a trade deal agreement, as it likely will be exclusive more than inclusive in its reach.

Talks are now addressing trade between the U.K. and E.U. after Brexit. These talks

are likely to focus on the terms for a "transition period" of two years or so to smooth the change in relations.

Prime Minister May says leaving the E.U. with no deal would be better than signing the U.K. up to a bad one. Without an agreement on trade, the U.K. may have to resort to operating under World Trade Organization ("W.T.O.") rules, which could mean customs checks and tariffs on goods as well as longer border checks for travelers. This raises the question of which is more valuable: time and inconvenience costs of no deal or lost revenue arising from a bad deal.

There are questions about Britain's current position as a global financial center, and the U.K.-Ireland border issue likely will fester.

OUTLOOK FOR U.S. BUSINESSES

The big unknown is negotiation of a trade agreement between the U.S. and the U.K. Presently, the E.U. and the U.S. have the largest bilateral trade and investment relationship and enjoy the most integrated economic relationship in the world. When the U.K. quits the E.U., it will not be part of these arrangements, and the terms of a new relationship must be hammered out with the U.S.

The key body in all of this is the W.T.O. Until Brexit Day, the U.K. is a member via its membership in the E.U. The U.K. will automatically become a member in its own right as soon as it leaves the E.U. Until a new trade deal with the E.U. is reached, trade will be conducted under W.T.O. rules after Brexit Day.

The U.K. is glancing anxiously across the Atlantic at how the U.S. will react to Brexit. President Obama, during his time in office, said the U.K. would need to go "to the back of the line" in trade discussions with the U.S. President Trump appears to have taken a contrary view. The new U.S. ambassador to the U.K., Woody Johnson, insisted the special relationship between the two countries will remain as strong as ever once Britain leaves the E.U. He has stated that the U.K. would always have a "strong and reliable trade partner" in the U.S. regardless of the outcome of Brexit and insisted the ties would not be harmed. "Our position on Brexit is clear. We want a strong and prosperous UK to remain a leader in Europe, and we want both the UK and the EU to remain strong leaders globally." In comparison to the former president, Mr. Johnson said, "As far as the president is concerned, the United Kingdom, our most enduring ally, is always at the head of the line." Mr. Johnson also added that the "lure" of working with Britain remains the same today as when his grandfather chose the U.K. to establish the company's first overseas subsidiary, over 100 years ago. He added:

> Our countries are among each other's largest inward investors. Americans and Brits hold roughly one trillion dollars of investment and employ approximately one million people in each other's countries — jobs that have increased prosperity and opportunity in all four countries of the United Kingdom and in every American state.

The British government is confident that it will procure a trade deal with the E.U., taking the best elements of deals the E.U. has already concluded with Canada, Japan, and South Korea as examples.

QUO VADIS THE U.K. POST-BREXIT TAX REGIME?

V.A.T., Customs Duties, and Other Indirect Taxes

V.A.T. is chargeable on most goods and service supplies within the E.U. The law is fairly harmonized, although Member States have a degree of discretion over rates and collection methods. In addition, the U.K. has been granted derogations (a European term for exceptions) allowing the zero-rating of certain classes of goods. Customs duties on imports into the single market are also harmonized, and E.U. law prevents taxes being levied on the raising of capital. Indeed, a past attempt to impose a stamp duty charge on certain share issues in the U.K. was ruled contrary to E.U. law.

A departure from the E.U. will simultaneously restore the U.K.'s sovereignty over tax-setting while access to the single market will be limited. Thus, the U.K. will gain the power to overhaul its tax system but its global businesses will become subject to E.U. customs duties unless a beneficial customs arrangement is negotiated.

In one scenario, not much may change. V.A.T. forms a sizeable part of the U.K. government's tax intake and there will be little benefit in deviating significantly from the existing, E.U.-derived system, save perhaps creating further exemptions or rates for particular classes of goods. If the U.K. joins the European Free Trade Association, like Norway or Switzerland, it will benefit from a special customs procedure that suspends customs and excise duties and V.A.T. on goods that pass through the U.K. to an E.U. destination. Further tax reliefs could be negotiated via bilateral trade agreements. The U.K. tax authorities will have more freedom to apply transfer duty to certain share issues, but moves of this kind are unlikely from a practical perspective and would be seen as counter-productive to new investment.

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In another scenario, there will be no V.A.T.-free trading area between the U.K. and the remaining Member States. Customs duties may be imposed as goods move between the U.K. and the E.U. This would inevitably bring with it increased paperwork, delays and additional administration.

Until a trade deal is reached, the W.T.O. trade rules will apply. The likely result is higher import duty rates and increased import V.A.T. on imported goods as V.A.T. is calculated on the duty-inclusive value of imports.

Direct Taxes: Company Profits and Capital Gains

Brexit Day will mark the end of the U.K.'s obligations and rights under various E.U. laws designed to reduce the burden of direct tax for companies doing business across the single market. The Parent-Subsidiary Directive simplifies profit distributions between E.U. group companies by preventing double taxation and abolishing withholding taxes on dividend payments. The Mergers Directive simplifies the reorganization of groups based in more than one E.U. Member State, while the Interest and Royalties Directive removes withholding taxes on intra-E.U. interest and royalty payments between associated companies. All of these directives are enacted via legislation that, from the U.K. side, is likely to remain in place post-Brexit. Additionally, tax treaties have a significant crossover with some of these rules and will remain in place post-Brexit. However, as these tax rules will over time diverge from E.U. rules, taxation will inevitably become more complex and burdensome

for M.N.E.'s that have group companies in both the U.K. and E.U. The U.K. will also lose its protection against discriminatory tax measures being imposed by E.U. Member States, putting it at risk of a tougher commercial environment and eroding the strategic benefit for investors of locating intermediate holding companies in the U.K. The U.K. will be free, in turn, to amend its direct tax legislation to create a more competitive environment. But substantial divergence from the E.U. system might make the U.K. less attractive to inward investors and reduce its leverage in negotiations with the E.U., so is unlikely to happen. Further, an emphasis on global trade, rather than European trade, will ease burdens to some degree.

There are proposals within the E.U. to consolidate corporate taxes further. A proposed Anti-Tax Avoidance Directive was agreed on June 21, 2016 and the E.U.'s proposed consolidated corporate tax base has reared its head again. The U.K. is generally against such further integration, so leaving the E.U. will have a potential benefit in this respect. The reality is, however, that most U.K. groups either have substantial interests in other E.U. Member States or trade with such states. E.U. measures will therefore continue to have relevance after Brexit.

The U.K.'s 19% corporation tax rate (with the government's stated intention to reduce it further in April 2020 to 17%) is the lowest among the G-20 nations. The U.K. also has a favorable holding company regime. It boasts the world's most extensive Double Tax Agreement network with dividends paid by underlying non-U.K. subsidiaries subject to, in many countries, nil or reduced withholding taxes. Dividend income received by U.K. companies is generally tax-free. And lastly, on the subject of dividends, these are paid out by a U.K. company free of any U.K. withholding tax to shareholders anywhere in the world, be they companies, trusts, foundations, or individuals. Additionally, U.K. holding companies benefit from favorable capital gains tax legislation for companies wishing to divest themselves of subsidiaries (the "Substantial Shareholding Exemption"). In most instances, this results in a zero-tax bill on the gain on disposal.

LIKELY UPSIDES

Although Brexit brings much uncertainty, there are potential positives:

- The U.K. is a member of the G-20, O.E.C.D., and W.T.O. independently from its membership in the E.U. It will thus continue to be a party to Double Tax and other agreements that have their basis in these international organizations. Indeed, a departure from the E.U. will give the U.K. more freedom over the method and pace of its implementation of the O.E.C.D.'s B.E.P.S. project, and other large-scale harmonizing initiatives.

- E.U.-wide measures can make Member States less competitive and create dual levels of accountability (*e.g.*, the proposed Anti-Tax Avoidance Directive, which includes a General Anti-Abuse Rule requiring Member States to meet certain minimum anti-abuse requirements). The U.K. has objected to proposals to harmonize corporation tax rules (the Common Consolidated Corporate Tax Base) and to introduce a new investor-state dispute resolution system (the Investment Court System), which would apply to all future E.U. agreements. If investors balk at measures of this kind, the U.K. might be viewed as an attractive host state by virtue of no longer being subject to them.

IN CONCLUSION

Much water remains to flow under the Brexit bridge. Hence, it is difficult to prognosticate life after Brexit Day. Any advice given will undoubtedly be driven by whether a hard or soft Brexit is likely to occur. The signs right now suggest that a soft Brexit is the more likely scenario, but the scenario can change overnight.

The conclusion of a favorable trade deal with the E.U. will be a major driver. Both the E.U. and the U.K. stand to gain from continuing the mutually beneficial trading environment, and there is significant interdependence that benefits both sides of the English Channel. A good example is the motor industry. Britain assembles several well-known car models, and in doing so, many parts are imported from the E.U. Will the U.K. government really seek to charge V.A.T. and duties on such parts, thereby making the cars more expensive to sell and putting a significant number of jobs at risk? Will the E.U. impose duties on the importation of such cars from the U.K. by E.U. distributors?

Equally important, will a post-Brexit world bring with it a more benign or more complex business environment in the U.K.? Will the banks desert the U.K. as a major world financial center, accompanied by the exit of many high earning executives taking their tax payments to other countries? What about Scotland, which voted in to remain in the E.U.? It is now faced with a Brexit it doesn't want, and its first minister has campaigned vigorously for Scotland's right to retain post-Brexit access to the E.U. single market. ("If a special case can be made for Northern Ireland, why not for us?")

Finally, petty local interests may intervene, attempting to stake out non-competition areas regarding certain parts of trade. Farmers, dairies, and energy are notable examples. They may also demand mandatory use of forums in home countries to resolve trade disputes.

There are so many questions and unknowns. The best advice for now, to those businesses considering the U.K. as a trading or investing partner, may well be to refrain from making any knee-jerk decisions, to keep a close watch on developments, and to act soonest thereafter. Basing a business decision on tenuous assumptions now may lead to a discovery that that the assumptions were groundless and prove to be unnecessarily expensive. On the other hand, missing the boat to relocate a business close to a market may itself be expensive if the lost opportunity cannot be regained.

While this may reflect a certain amount of fence-sitting, it may prove better in the long run than coming down irretrievably on the wrong side.

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