Lex et Brexit — The Law and Brexit

Davis Polk

August 19, 2016

ISSUE 4

Contents

As we enter the second half of August, no substantial progress has been made towards finalising Britain's objectives in the upcoming Brexit negotiations. The EU and the UK seem to have accepted that there will be no quick triggering of Article 50 before the end of the year. Nevertheless, it is to be hoped that once the corridors of power in Westminster and Brussels fill again after the summer break, some picture of a plausible UK negotiating position might begin to emerge.

In the fourth edition of Lex et Brexit, we consider Brexit's implications for fiscal policy in the UK. Specifically, we examine how Brexit might impact the UK's existing tax regime and the proposed changes to the UK's tax regime arising out of various international and EU initiatives. We also discuss what Brexit might mean for the UK's continued attractiveness as a corporate tax jurisdiction – and whether this may, in fact, be bolstered by Brexit. We conclude that Brexit presents an opportunity for the UK to enhance its credentials as a flexible and well-balanced corporate tax jurisdiction, but that the UK will need to balance healthy tax competition against preserving its reputation as a 'good citizen' in the international tax world. It remains to be seen what approach the UK Government will take.

We then examine the impact of Brexit on the regulation of credit rating agencies ("**CRAs**") in the UK. UK CRAs are currently directly regulated by the European Securities and Markets Authority ("**ESMA**"), which means that Brexit will inevitably have consequences for their regulation. We conclude that, although the European legislation contains mechanisms for the regulation of third country CRAs – which is what the UK CRAs would become following the UK's withdrawal from the EU – it is unclear whether these will be sufficient to enable UK CRAs to continue to operate in the same way as they do today. We expect that UK CRAs may be pressurized to move certain of their EU activities from the UK and into the EU, where these activities can be directly regulated by ESMA.

Brexit – a 'Reset' of Fiscal Policy?

Following the Brexit referendum, HM Revenue & Customs ("**HMRC**") recorded a telephone message on its phone lines in which taxpayers were assured that "everything is continuing as normal". Of course, the referendum itself had no impact on the UK's tax system. In fact, as policy on direct taxation has generally been a matter for member states to determine themselves (subject to compliance with general EU principles on matters such as free movement and state aid), the view expressed in a post-referendum UK Parliamentary Briefing Paper was, understandably, that "the implications of the UK lying outside the EU are likely to be less significant for taxation compared with other policy areas".

Indeed, until there is more clarity around what form Brexit may take (including whether or not the UK remains a member of the European Economic Area (the "**EEA**")), it is too early to say in detail what effect Brexit may have on the UK's corporate tax system.

Perhaps the first meaningful opportunity to take stock of the Brexit impact on tax will be at the Autumn Statement, probably in early December 2016. This is the main policy event of the UK's fiscal calendar after the Budget, and the first to be delivered by the new Chancellor of the Exchequer, Philip Hammond. In comments made last month the Chancellor said that there will be an opportunity, at the Autumn Statement, "to reset fiscal policy if we deem it necessary to do so" in light of post-referendum data. It remains to be seen what such a 'reset' might involve for corporate taxpayers.

More generally, the Brexit referendum has come at a time when the UK, the EU and the Organization for Economic Co-operation and Development ("**OECD**") are all progressing ambitious agendas in the sphere of international corporate tax.

In this edition of Lex et Brexit we take a look at how Brexit may impact both (i) the UK's existing tax regime and (ii) proposed changes to the UK's tax regime in the light of OECD and EU related tax initiatives. We also consider what this may mean for the UK's continued attractiveness as a corporate tax jurisdiction. Accordingly, in what follows we focus on corporate tax issues rather than indirect taxes such as VAT and customs duties – though Brexit may well, in due course, have a significant impact on these taxes, which to a large extent are harmonised across the EU.

Brexit's implications for implemented EU tax directives

Payments of interest, royalties and dividends

The Interest and Royalties Directive and the Parent-Subsidiary Directive are relatively rare examples of EU legislation in the direct tax sphere. These measures disapply withholding taxes, broadly, on interest, royalty and dividend payments between associated companies in EU member states.

Were the UK to leave the EU, it is possible that such payments to a UK incorporated recipient company could then be subject to withholding taxes levied by other member states. However, whilst this could be problematic for UK-headed groups with certain fact patterns – and groups currently relying on these Directives may now want to re-examine their structures – it seems unlikely that the loss of access to these Directives need be a significant blow to the UK's attractiveness as a holding company jurisdiction generally, given the UK's wide network of double tax treaties with other EU member states.

Indeed, it is not uncommon for a group's holding company to be UK tax resident but incorporated outside the EU, for example, in Jersey, Bermuda or the Cayman Islands. While such companies, even now, would not be eligible for the benefit of the Directives mentioned above, this point has not generally proved problematic in practice.

Cross-Border mergers

EU Directives provide for a corporate law and tax regime which enables cross border merger transactions between companies established in EU member states to be undertaken on a neutral basis for direct tax purposes. This regime has been used on a number of public M&A transactions involving combinations of groups beneath a UK holding company. While these measures have been implemented in UK domestic law and accordingly would in principle remain in force on Brexit, UK companies may no longer be eligible for the benefits of this regime in other member states if the UK were to leave the EU.

Stamp taxes and listing in the US

A notable development in equity capital markets transactions in recent years has been the ability of UK listed companies to issue new shares directly on NYSE or NASDAQ without incurring a charge to UK stamp duty reserve tax ("**SDRT**"). This is because case law has established that the 1.5% SDRT charge in UK legislation on the issue of shares to a clearance service (such as the Depository Trust Company, the clearance service which supports trading on NYSE and NASDAQ) is contrary to the EU law requirements of the Capital Duties Directive. Since 2012 HMRC has accepted this and its published practice is no longer to collect SDRT in these circumstances.

On Brexit, the status of this guidance would be called immediately into doubt. Whether HMRC will seek to re-impose the 1.5% charge on share issues – which for many years was a significant obstacle to be managed on M&A transactions – remains to be seen. We may see a return of former techniques that were employed to mitigate the full effect of the 1.5% charge (see for example some of the early US inversions, including Aon's redomiciliation to the UK in early 2012, and the unification of Royal Dutch Shell in 2005). Other more esoteric planning options may also be available.

Brexit's impact on the UK's double tax treaties

The UK's double tax treaties are entered into bilaterally between the UK and other countries, and their validity will not be impacted by Brexit. There may however be important points of detail to consider if the UK is no longer an EU member state (or, potentially, a member of the EEA). It is not uncommon, for example, for the 'derivative benefits' limb of the Limitation on Benefits article in US double tax treaties with EU member states to entitle a company in the EU jurisdiction to the benefit of the treaty where (among other matters), that company is owned by a small number residents of the EU or the EEA. Perhaps somewhat counter-intuitively, a Dutch or an Irish sub-holding company, for example, held beneath a listed UK holding company, might find itself unable to qualify for US treaty benefits under this limb, while conceivably the entitlement of the UK holding company to US treaty benefits itself might remain unaffected.

Brexit and 'BEPS' – changes in the pipeline

The most significant undertaking in the international tax arena in recent years has been the OECD's wide-ranging reform project targeting 'Base Erosion and Profit Shifting' ("**BEPS**"), which looks to tackle perceived aggressive cross-border tax planning techniques practised by multinationals.

The UK has been an early and vocal supporter of the BEPS project. The UK Government's response to BEPS includes proposed rules addressing hybrid entities and instruments, interest deductibility, as well as the tightening up of an arguably over generous IP tax regime (the so called patent box).

BEPS aside, the UK has also taken unilateral action to protect its tax base, including introducing the so-called "Google tax" to target, among other matters, group structures which artificially avoid creating a UK permanent establishment, and extending its taxing rights over cross-border IP royalty payments and trading profits from dealing in or developing UK land.

Short of a major reset of corporate tax policy, these measures look like they are here to stay.

Impact of future EU developments

The EU has also taken action in response to the BEPS project. In July this year it adopted the so-called 'Anti-Tax Avoidance Directive' (the "**ATAD**"). While the UK remains a member state, the ATAD is of course binding on the UK. Member states are required to implement its provisions generally from 2019.

The recitals in the Directive declare that the ATAD is consistent with the OECD's conclusions, and is necessary to ensure 'coordinated implementation' of those conclusions.

The ATAD introduces interest limitation rules and anti-hybrid rules that are broadly consistent with BEPS.

However, the ATAD appears to go a good deal further than the BEPS project. For example, the ATAD contemplates rules relating to exit taxation on certain 'intra-entity' transactions, whereby assets of a taxpayer are 'transferred' out of a member state, for example by way of allocation to its permanent establishment in another member state or third country, or by the taxpayer migrating its residence.

Further, it introduces a broad ranging general anti-abuse rule ("**GAAR**") to counteract transactions (including purely domestic transactions) that are 'not genuine' (as defined). ATAD also requires all member states to introduce a controlled foreign companies ("**CFC**") regime for apportioning income in low tax subsidiaries to the parent jurisdiction. Some of the UK's tax competitors, such as Ireland, Luxembourg and the Netherlands, do not currently have a CFC regime.

The ATAD may also be seen as a further (to some, highly unwelcome) movement towards direct tax harmonization in the EU – a trend which the UK has resisted. It is therefore possible that, post-Brexit, direct tax harmonization in the remaining member states could accelerate.

Developments to look out for may include:

- The Common Consolidated Corporate Tax Base ("**CCCTB**"). Following a relaunch last year, the European Commission is expected to publish legislative proposals later this year for an EU CCCTB in the EU: mandatory harmonised rules for computing corporate taxable profits, allowing for cross-border loss relief, and apportioning a consolidated group's tax base across the EU.
- An EU-wide withholding tax? The European Parliament's TAXE 2 committee recently called on the Commission to propose legislation for an EU-wide withholding tax to be levied on profits generated within the EU.
- State aid and transfer pricing. In certain high profile state aid disputes, there have been clear signs that the Commission is looking to develop a distinct, EU-wide interpretation of the arm's length principle in light of EU competition law, independent of OECD guidelines and their application by tax authorities in member states. Given the perceived focus of these enquiries on US multinationals, this area has become a politically sensitive one for relations between the US and the EU.
- Financial Transactions Tax ("**FTT**"). The UK was an opponent of the Commission's attempts to introduce an FTT. The current proposals, being taken forward by a group of ten participating member states under a special procedure, are progressing slowly, however, and the implementation of an FTT does not look imminent.

Conclusions

There is no reason why Brexit should mean that the UK's tax regime becomes an impediment to doing business in the UK, or to structuring cross-border deals using UK entities. In terms of deterrents to foreign direct investment in the UK, the political and economic ramifications of Brexit will, in our view, likely be more significant than tax.

Indeed, Brexit may well provide an opportunity for the UK to bolster its credentials as a flexible and well-balanced corporate tax jurisdiction. In particular, were the UK to leave the EU and not be subject to ATAD or the other EU harmonization initiatives discussed above, the UK would have considerably greater discretion to set its own competitive corporate tax policy. (The UK Government might recall Rahm Emanuel's recommendation never to let a good crisis go to waste…)

At the other end of the spectrum, however, it is open to question whether the UK's competitiveness might, to some extent at least, be jeopardized by its current willingness unilaterally to expand its tax base, and its commitment vigorously to adopt certain BEPS measures. The performance of the UK's economy and public finances may also constrain the Government's ability to reduce the corporate tax burden.

Furthermore, post-Brexit there will be a need to balance healthy tax competition against preserving the UK's reputation as a 'good citizen' in the international tax world – a factor which has itself contributed to the UK's success to date as a corporate tax domicile. Perceptions that the UK is using its tax system to compete too sharply with the EU and other economies could lead to accusations of 'tax dumping', and demands for retaliatory measures. With the UK's corporation tax rate set to fall to 17% from 2020 (and there have been calls for it to fall further still), it is not inconceivable that the UK could find itself viewed effectively as a 'tax haven' from the perspective of other member states.

In light of Brexit, and the Chancellor's hints at a 'reset' of fiscal policy, it seems a good moment to recall the published policy of successive UK Governments of seeking to create the most competitive corporate tax regime in the G20. It will be interesting to see to what extent the new Chancellor will remain committed to this goal.

Brexit's Implications for the Regulation of Credit Rating Agencies

Brexit will likely impact every aspect of financial services law in the UK. Some topics – including the availability of the financial services passport under the Markets in Financial Instruments Directive – have received much coverage (please see the first issue of Lex et Brexit for our thoughts on the passporting issue), while others have not. Here, we consider one of the less high profile issues, Brexit's implications for the regulation of CRAs in the UK.

The supervisory mechanism for EU CRAs

The EU Credit Ratings Agencies Regulation (as amended, the "**CRA Regulation**") is the key piece of EU legislation relating to credit ratings and CRAs, which was created to address concerns that arose during the financial crisis of 2008-09 about the use of credit ratings in the financial markets. The CRA Regulation has been amended twice since it came into force in December 2009. As a regulation, the CRA Regulation has direct applicability in each member state of the EU without the need for implementation into national law. The CRA Regulation provides that EU financial institutions cannot use credit ratings issued by an EU CRA for regulatory purposes[1] unless that CRA has been registered with ESMA. Only EU CRAs can be registered with ESMA.

CRAs are the only financial market participants directly regulated by ESMA rather than national regulators. ESMA has established a system of intensive supervision for CRAs, which is comparable to the regulatory regime imposed on financial market infrastructures such as central counterparty clearing houses. ESMA's form of oversight involves, *inter alia*, supervisory visits by ESMA staff to CRAs and assessments of their credit rating methodologies.

If the UK remains in the EEA, it is likely that the regulatory regime applicable to CRAs will be fundamentally unchanged. If, however, EEA membership is not maintained, the UK would become a "third country" for the purposes of the CRA Regulation.

The supervisory mechanism for third country CRAs

EU financial institutions cannot use credit ratings issued by a third country (i.e., non-EEA) CRA for regulatory purposes unless: (i) that credit rating has been endorsed by a registered CRA; or (ii) the third country CRA has been certified by ESMA.

Endorsement – the "chaperone" approach

The CRA Regulation sets out a mechanism by which a registered CRA may endorse a credit rating issued in a third country, which enables that credit rating to be treated as a credit rating issued by a registered CRA. This means that an EU financial institution may use this credit rating for regulatory purposes.

A registered CRA may endorse a credit rating issued in a third country only when the conditions laid out in the CRA Regulation are satisfied, which means:

---

[1] The CRA Regulation defines "regulatory purposes" as the use of credit ratings for the specific purpose of complying with EU law, or with EU law as implemented by the national legislation of member states (Article 3(1)(g), CRA Regulation). This includes, for instance, using a credit rating to calculate one's capital requirements under the Capital Requirements Regulation and the Capital Requirements Directive IV.

(a) The credit rating activities resulting in the issuance of the credit rating must be undertaken in whole or in part by the registered CRA or by CRAs belonging to the same group.

(b) The registered CRA must verify, and be able to demonstrate on an ongoing basis to ESMA, that the conduct of the credit rating activities by the third country CRA resulting in the issuance of the credit rating fulfils requirements that are at least as stringent as certain requirements set out in the CRA Regulation.

(c) ESMA's ability to assess and monitor the compliance of the third country CRA with the requirements referred to in point (b) must not be limited. The registered CRA must, for example, make available on request to ESMA all the information necessary to enable ESMA to assess and monitor compliance.

(d) There must be an objective reason for the credit rating to be produced in a third country.

(e) The third country CRA must be authorised or registered, and be subject to supervision, in that third country.

(f) The regulatory regime in that third country must prevent interference by the authorities of that third country with the content of credit ratings and methodologies. This condition does not apply where the European Commission has recognized the legal and supervisory framework of that third country as equivalent and co-operation arrangements between ESMA and the relevant supervisory authority of the third country CRA are operational.

(g) There must be appropriate co-operation arrangements between ESMA and the relevant supervisory authority of the third country CRA.

Where a credit rating is issued pursuant to this mechanism, that rating must be clearly identified as having been endorsed by a registered CRA. The registered CRA will be fully responsible for the credit rating and the fulfilment of the conditions for endorsement. Thus, the registered CRA effectively acts as a "chaperone" of the third country CRA for the provision of its credit ratings in the EU.

Certification based on equivalence

Alternatively, a third country CRA could seek certification from ESMA, which would enable EU financial institutions to use its credit ratings for regulatory purposes. It is important to note, however, that such a CRA can conduct credit rating activities in the EU for regulatory purposes only with respect to credit ratings concerning issuers established, or financial instruments issued, in third countries. This would mean, for example, that a UK-established CRA might be disadvantaged in rating the securities of EU issuers even if ESMA certification were achieved.

Certification requires the conditions set out in the CRA Regulation to be satisfied, which means:

(a) The third country CRA must be authorized or registered, and be subject to supervision, in that third country.

(b) The European Commission must have adopted an equivalence decision that recognizes the legal and supervisory framework of that third country as equivalent to the requirements of the CRA Regulation.

(c) There must be appropriate co-operation arrangements between ESMA and the relevant supervisory authority of the third country CRA.

(d) The credit ratings issued by the third country CRA and its credit rating activities must not be of systemic importance to the financial stability or integrity of the financial markets of one or more member states.

(e) The credit rating agency must have been certified by ESMA. As part of the certification process, the third country CRA may be exempted from the requirement to have a physical presence in the EU.

The CRA Regulation lists the conditions that a third country's legal and supervisory framework must satisfy before the European Commission is able to consider the framework as equivalent. This means:

(a) CRAs in that third country must be subject to authorization or registration and effective supervision and enforcement on an ongoing basis.

(b) CRAs in that third country must be subject to legally binding rules that are equivalent to certain provisions of the CRA Regulation.

(c) The regulatory regime in that third country must prevent interference by the authorities of that country with the content of credit ratings and methodologies.

The European Commission has adopted equivalence decisions in relation to, *inter alia*, Canada, Hong Kong and the US. There is a question as to whether the UK's regulatory regime for CRAs would also be deemed equivalent following the UK's withdrawal from the EU. In this respect, it is significant that, as a regulation, the CRA Regulation will fall away once the UK withdraws from the EU unless it is transposed into UK law. It is possible that the UK Parliament will enact a law to take effect upon Brexit, which will provide for all EU legislation to continue to apply for a transitional period, so as to enable the UK Government to carefully assess such legislation and determine whether it should be maintained, amended or repealed. It would not make sense, however, for the CRA Regulation to be transposed into UK law entirely, as UK CRAs would no longer be supervised by ESMA following Brexit (which is what the CRA Regulation provides for). This leaves a regulatory gap, which the UK would need to fill. It is possible that the UK will do so in a way that is equivalent to the EU regulatory regime for CRAs, such as by imposing supervisory visits and assessments of methodologies by the Financial Conduct Authority ("**FCA**"), but this is by no means certain.

Furthermore, as with other EU financial services legislation that provides for third country access to the EEA (for example, the Markets in Financial Instruments Regulation and the Markets in Financial Instruments Directive II, the Alternative Investment Fund Managers Directive and the European Market Infrastructure Regulation), the process of achieving equivalence may be political and/or time consuming, particularly where ESMA and the European Commission might be concerned that the levels of supervision by the FCA might not match those levels currently imposed by ESMA. Timing could also be an issue, as there will be no obligation on the European Commission to begin an equivalence assessment process prior to an actual Brexit date. ESMA might also take a significant amount of time to certify a UK CRA following Brexit.

In any event, as noted above, a third country CRA that has been certified by ESMA can conduct credit rating activities in the EU for regulatory purposes only with respect to credit ratings concerning third country issuers or financial instruments. Where a certified CRA issues credit ratings that relate to EU issuers or financial instruments, those credit ratings cannot be used by EU financial institutions for regulatory purposes. To do the latter, the CRA must either be established in the EU and registered with ESMA, or its credit ratings must be endorsed by a CRA that is established in the EU and registered with ESMA.

Practical implications

The largest CRAs each have a number of European subsidiaries, which are registered with ESMA in different member states including the UK. Most of these CRAs' EU activities are, however, performed by their UK subsidiaries. As a result, it is possible that work will be shifted out of the UK and into the EU following Brexit. This will, at least in part, depend on the viability of the alternative mechanisms described above. It will also depend on whether the intensive supervisory regime established by the CRA Regulation will be replicated in UK law, with the FCA replacing ESMA as the relevant regulator. At first glance, UK-based CRAs might prefer to have the FCA as their regulator, and rely on having their ratings endorsed for CRA Regulation purposes by another group company in the EU. It is not wholly clear whether this will always be possible under ESMA's endorsement mechanism though, as, under the CRA Regulation, there would need to be an objective reason for credit ratings to be produced in the UK. The CRA Regulation does not define what constitutes an objective reason.

Ultimately, the fact that UK CRAs are currently directly supervised by ESMA means that Brexit will undoubtedly have consequences for their regulation. The CRA Regulation contains mechanisms for the regulation of third country CRAs, but it is unclear whether these will be sufficient to allow UK-established CRAs to continue to operate in the same way as they do today. Given the political hostility to CRAs in some parts of the EU, we expect significant pressure to be applied to CRAs to move the bulk of their EU business from the UK and into the EU, where the intensive ESMA supervisory regime can be applied.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Thomas J. Reid	**+1 212 450 4233**	tom.reid@davispolk.com
John D. Amorosi	**+1 212 450 4010**	john.amorosi@davispolk.com
John Banes	**+44 20 7418 1317**	john.banes@davispolk.com
Leo Borchardt	**+44 20 7418 1334**	leo.borchardt@davispolk.com
Jonathan Cooklin	**+44 20 7418 1311**	jonathan.cooklin@davispolk.com
Kirtee Kapoor	**+1 650 752 2025**	kirtee.kapoor@davispolk.com
Will Pearce	**+44 20 7418 1448**	will.pearce@davispolk.com
Simon Witty	**+44 20 7418 1015**	simon.witty@davispolk.com
Connie I. Milonakis	**+44 20 7418 1327**	connie.milonakis@davispolk.com
Michael Sholem	**+44 20 7418 1027**	michael.sholem@davispolk.com
Joanna A. Valentine	**+44 20 7418 1323**	joanna.valentine@davispolk.com
Dominic Foulkes	**+44 20 7418 1394**	dominic.foulkes@davispolk.com

About Lex et Brexit — The Law and Brexit

Lex et Brexit is our fortnightly publication on Brexit developments. In each issue, we select and discuss emerging legal issues from the maze of Brexit-related debates and developments.

Read previous issues at **www.davispolk.com/brexit >**

Sign up to receive Lex et Brexit >