Brexit: potential consequences on the tax relations between the UK and Italy

On June 24 the British people voted in favour of the UK leaving the EU. The vote itself does not automatically imply the withdrawal from the EU: indeed, such withdrawal shall take place pursuant to Article 50 of the EU Treaty, which requires in the first place the notification of the intention to leave the EU by the UK to the European Council. The UK will then have to negotiate with the EU the terms and the conditions of its withdrawal. For the time being, the terms of the UK withdrawal from the EU cannot be foreseen and, therefore, the consequences of such withdrawal are still uncertain. Hereby, we highlight some of the main tax consequences, regarding the relationship between the UK and Italy, which might derive from the UK withdrawal, bearing in mind that such consequences will be affected by the outcome of the aforementioned UK-EU negotiations and by the possible permanence of the UK in the European Economic Area (in which case some of the rules below would continue to apply).

Impact on primary EU law

In terms of primary EU law, the UK withdrawal will imply that the EU fundamental freedoms laid down in the EU Treaty will no longer apply in relation to cross-border economic activities between the UK and Italy, with the exception of the free movement of capital which will still apply vis-à-vis third (i.e. non-EU Member) States. This implies e.g. that UK companies setting up subsidiaries or branches in Italy will not be protected from discriminations in Italy pursuant to the EU freedom of establishment. Obviously, double tax treaty non discrimination rules will continue to apply and the UK and the EU may agree for the fundamental freedoms to continue to apply in their relations. Again on primary EU law, following its withdrawal, the UK will no longer be bound by the State aid ban embodied into Article 107 of the EU Treaty: this may grant more flexibility to the UK in terms of introducing attractive tax regimes for local businesses.

Impact on secondary EU law

In terms of secondary EU law, the UK withdrawal will trigger the non-application of the EU Directives and Regulations in the relations between EU Member States and the UK. With particular reference to tax law:

1. The Parent Subsidiary Directive, which provides for an exemption for inbound and outbound dividends paid between qualifying EU companies of different EU Member States, will cease to apply in the relations between EU Member States and the UK. Therefore, for instance, dividends paid by Italian subsidiaries to UK parent companies will become subject to withholding tax at the domestic tax rate, as reduced by the UK-Italy tax treaty (and, possibly, by the free movement of capital). Furthermore, also the Interest and Royalty Directive, which provides an exemption from withholding tax on outbound interest and royalty payments between qualifying associated companies of different EU Member States, will cease to apply in the relations between EU Member States and the UK, so that previously exempt cross-border interest and royalties will become subject to withholding tax in the State of source. Needless to say, the UK, similarly to Switzerland, may negotiate with the EU the application of a regime, for UK-EU cross-border dividends, interest and royalties, substantially similar to the regime under the aforementioned Directives. Absent this, the structure of corporate groups will need to be reviewed in order to minimize the adverse consequences deriving from the different legal framework;
2. The Merger Directive, which grants, under certain conditions, a tax-free (neutral) regime to restructuring transactions between qualifying companies of different EU Member States, will cease to apply in the relations between EU Member States and the UK, so that cross-border reorganisations may become more burdensome (aside to this, also the legal framework of cross-border mergers could change since corporate law directives would no longer apply too);
3. The Directives on exchange of information and assistance in the recovery of tax claims will cease to apply in the relations between EU Member States and the UK. However, information between the Tax Authorities could still be exchanged under the relevant rules of international tax law, including double tax treaties and the Multilateral Convention on Mutual Assistance in Tax Matters;
4. Further and foremost, in terms of indirect taxes, not being bound by the VAT system, supplies of goods from the UK to the EU and from the EU to the UK will not qualify as intra-Community supplies but, rather, as importations (subject to VAT) into the EU or exportations from the EU respectively. This will also have an effect in terms of VAT obligations. For instance, UK established persons will need to appoint a VAT representative in order to exploit VAT rights and comply with obligations whilst, for EU taxable persons, VAT registration can be done directly. Moreover, the withdrawal from the EU will put the UK outside the single trading area and, therefore, supplies of goods from the UK to the EU will be subject to excise duties upon their import;
5. The Anti-Tax-Avoidance Directive, which obliges Member States to introduce in their domestic legislations five anti-abuse measures against common forms of aggressive tax planning, will not apply to the UK. In addition, for the purpose of this Directive, Member States will regard the UK as a third State and therefore e.g. the tax regime of participations in subsidiary companies resident of the UK may be negatively affected by controlled foreign company rules contained in the Directive.

Impact on EU soft legislation

The UK withdrawal from the EU will further imply that so called European soft legislation (codes of conduct, recommendations, communications, etc) will not be addressed to the UK anymore. For instance, despite the fact that the UK withdrawal will not affect by itself the application of the Arbitration Convention on transfer pricing adjustments involving companies resident of the UK (since the Arbitration Convention is not EU legislation but it is a multilateral tax treaty signed by individual States, including the UK), the code of conduct issued by the EU Council for the effective implementation of such a convention will not be addressed anymore to the UK. Furthermore, EU Member States will not be addressed anymore by the same code of conduct in relation to transfer pricing adjustments involving companies resident of the UK since the above code of conduct deals with the application of the Arbitration Convention (and tax treaties) to transfer pricing adjustments between affiliated companies resident of different EU Member States. As a further example, the Commission Recommendation of 28.1.2016 on the implementation of measures against tax treaty abuse, part of the Anti-Tax-Avoidance Package together with the aforementioned Anti-Tax-Avoidance Directive, will not be addressed anymore to the UK once outside the EU.

Impact on Italian domestic legislation

Within Italian domestic law, several specific provisions applicable only to taxpayers of EU Member States were introduced. The UK withdrawal will trigger that the regimes laid down by the above-mentioned domestic provisions for EU Member States will not apply in the relations with the UK (such provisions sometimes apply also vis-à-vis EEA Member States that effectively exchange information with Italy, although we hereby focus on their application towards EU Member States). The aforementioned regimes include, among the others, the following:

1. The reduced domestic withholding tax (1.375%, instead of 26%) on outbound dividends paid to entities that are resident of an EU Member State and subject to corporate income tax therein;
2. The reduced domestic withholding tax (11%, instead of 26%) on outbound dividends paid to pension funds set up in an EU Member State;
3. The exemption from withholding tax on outbound interest due on medium-long term loan paid to banks established in an EU Member State and insurance companies incorporated and authorized pursuant to the legislation of an EU Member State (such interest may still qualify for the exemption for institutional investors established and subject to supervision in States that effectively exchange information with Italy);
4. The exemption from withholding tax on outbound interest paid on bonds issued by companies with shares traded on a regulated market or multilateral trading system of an EU Member State and on bonds traded on a regulated market or multilateral trading system of an EU Member State;
5. The reduced 5% withholding tax on outbound interest to be used by the recipient to fund the payment of interest on qualifying bonds traded on a regulated market of an EU Member State;
6. The deferral of the levy of exit tax upon the transfer of residence to an EU Member State (it is to be investigated whether the UK withdrawal from the EU might lead to the termination of the deferral regime for transfers to the UK occurred prior to the UK withdrawal on the ground of the provisions whereby the deferral regime is terminated when there is a subsequent transfer from the foreign EU Member State to a third State);
7. The right to establish a fiscal unity between resident sister companies controlled by a parent company that is resident of an EU Member State and the right to include in a fiscal unity (as consolidated entity) the Italian permanent establishment of a controlled company resident of an EU Member State;
8. The non-application of the set of CFC rules based on the foreign nominal tax rate to controlled companies resident of an EU Member State (the set of CFC rules based on the foreign effective tax rate may already apply to EU Member States);
9. The option for the levy of the substitute tax on medium-long term loans granted by banks established in an EU Member State, insurance companies

incorporated and authorized pursuant to the legislation of an EU Member State and investment funds set up in an EU Member State;

10. The exemption from the levy of the FTT (Financial Transaction Tax) for transactions carried out by pension funds set up in an EU Member State and subject to regulatory supervision in their home country pursuant to Directive 2003/41/EC;
11. The granting of a tax credit to Italian pension funds in relation to qualifying investments (e.g. shares, bonds, units of investment funds) in an EU Member State;
12. The entitlement of resident companies (as well as companies resident of an EU Member State with an Italian permanent establishment) with shares traded on a regulated market of an EU Member State to opt for being treated as a listed real estate company (SIIQ);
13. The levy of the flat rate 26% tax (instead of progressive tax rates) to distributions from EU investment funds to resident individuals;
14. The exemption from inheritance and gift tax for transfers in favour of qualifying charitable entities established in an EU Member State, as well as for transfers aimed at pursuing a qualifying charitable purpose in favour of public entities, foundations and associations established in an EU Member State (an exemption may still apply subject to a reciprocity condition);
15. The exemption from inheritance tax for public bonds issued by an EU Member State;
16. The levy of wealth tax on real estate situated in another EU Member State on the foreign deemed value relevant to foreign wealth or income taxes, rather than on the basis of the purchase price (for real estate in the UK, the tax authorities recognised, as a relevant foreign deemed value, the value for Council Tax purposes);
17. The right for non-resident insurance companies operating in Italy under the freedom to provide services to act as withholding agent for the purpose of levying a final substitute tax (and thus lifting reporting obligations for the recipients of the income) in relation to the income of individuals from life insurance policies;
18. The possibility to enter into a VAT consolidation arrangement (that, differently from the VAT grouping arrangement, maintains taxation of intra-group supplies) that, under the current interpretation of the Italian tax authorities, is available to non-established companies only to the extent such companies are established in another EU Member State;
19. The possibility for holding companies of other EU Member States having a consolidated net worth higher than € 250 million to guarantee the refund of excess input VAT (or offset it within a VAT consolidation arrangement);
20. The possibility to apply for direct VAT refund for non-established taxable persons. For non-EU Member States such possibility is allowed only if a bilateral agreement is concluded(so far only Norway, Israel and Switzerland have concluded such an agreement).

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