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# Tax Aspects of Leaving the European Union

## 1. Introduction

It is a great honour to participate in a Festschrift for Professor Wlodzimierz Nykiel. He has been a good friend and colleague within our EUCOTAX group and, despite his many other duties, such as Rector of University of Lodz, he participated in our yearly Wintercourse program.

In this contribution, I will discuss some income tax aspects, in particular corporate tax issues of the United Kingdom[2] leaving the European Union, from a Swedish perspective. However, I think our experiences are of a general nature and can be useful also for colleagues in other member states. The United Kingdom (UK) left the European Union (EU) on 31 January 2020 after being a member since 1973. It had adjusted its domestic tax laws to EU law, and so had Sweden. In its income tax laws, Sweden took for granted that the UK is, and will continue to be, an EU member. When the current tax treaty between Sweden and the United Kingdom was negotiated and finally concluded in 2015, the United Kingdom was still a member of the European Union, and, at least subconsciously, this was in the minds of the treaty negotiators.

The Agreement on the withdrawal of the United Kingdom and Northern Ireland from the European Union and the European Atomic Energy,[3] entered on 24 January 2020, generally known as Brexit agreement, dealt with the conditions for the withdrawal but also regulated the transitional period until 31 December 2020.



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[2] I will use the short form United Kingdom, or UK, instead of the United Kingdom of Great Britain and Northern Ireland.

[3] EUT L 29, 31 January 2020.

At the end of 2020, a trade and cooperation agreement between the European Union and the United Kingdom was concluded. The trade agreement went into effect in 2021, but there seems to be no provisions affecting income taxation in that agreement.

The income tax landscape has been altered because as a member of the EU and the European Economic Area, EEA, a state is bound by both EU primary law (primarily the Treaty on European Union, TEU, and the Treaty on the Functioning of the European Union, TFEU) and as a member of the EU, bound by EU secondary law (e.g. the corporate tax directives, such as the Merger Tax Directive[4] and the Parent-Subsidiary Directive[5]). When the United Kingdom no longer is a member of the European Union the binding effects of EU law disappears. This affects both the United Kingdom and the remaining EU member states, in my case Sweden.

The provisions in TFEU on free movement of goods (Art. 34), freedom to provide and receive services (Art. 56), free movement of capital and payments (Art. 63), free movement of EU citizens (Art. 21) of workers (Art. 45) and freedom of establishment (Art. 49) as well as state aid (Arts. 107 and 108) all affects the design of national tax rules. With the exception of the free movement of capital, these articles cease to be applicable on movements between Sweden and the United Kingdom.



As part of Sweden's ambition to be loyal to its obligations towards the EU, many income tax provisions have been amended in order to conform to EU primary law. For many statutory provisions to apply, it the transaction at issue must involve a member state of the EEA. For instance, a deferral of capital gains tax after an exchange of shares is only permitted as long as the individual is a resident of an EEA state. In another example, in order to qualify under the group contribution rules (provided that other requisites are met) group companies must be resident in a member state of the EEA. As the statute specifically mentions residence in an EEA-member state, companies that reside in the United Kingdom do no longer qualify. Therefore, even if the statute itself has not changed, the fact that the statute refers to residence in an EEA-member state follows that Swedish subsidiaries of British parent companies can no longer benefit from the group contribution rules.

In those cases where Sweden has not (yet) adjusted its income tax rules to EU primary law, a taxpayer may nevertheless rely on the direct effect

[4] EU, Council Directive 2009/133/EC on the common system of taxation applicable to mergers, divisions, partial divisions, transfer of assets, and exchange of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States, OJ L 310, 25 November 2009, pp. 34–46.

[5] EU, Council Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries in different Member States, OJ L 345, 29 December 2011, pp. 8–16.

on primary law. That is normally not available in case it involves a British resident or transaction relating to the United Kingdom.

To sum up, the United Kingdom becomes a third state and taxpayers cannot rely on the fundamental freedoms (except capital), state aid provisions, etc. It means that both the United Kingdom and Sweden can have domestic tax provisions that restricts the free movement, and even have discriminatory provisions. Of course, there is a tax treaty between Sweden and the United Kingdom containing an article on non-discrimination. However, that article, modelled after Art. 24 of the OECD Model Tax Convention, will not catch many of the situations covered by the EU primary law. I will later give a few examples.

As regards EU secondary law, Sweden has implemented the corporate tax directives, primarily in the Income Tax Act,[6] ITA, but also in the Withholding Tax Act.[7] The corporate tax directives typically provide for a solution to a specific tax problem, where approximation of national tax laws is needed for the establishment or functioning of the common market (Art. 115 TFEU). For instance, the Parent-Subsidiary Directive provides for non-taxation at source in the state where the distributing company is resident, and corresponding non-taxation in the state of the company receiving the dividends. A corporate tax directive typically lists the applicable taxes and companies in two annexes (list of type of corporations in Annex A and list of national tax laws in Annex B).



Normally, the directives provide for minimum solutions, so that a member state can go even further in its domestic tax rules implementing the directive. In the case of the Parent-Subsidiary Directive, a member state is required to apply the directive when a qualifying company in one member state has a holding of at least ten percent in a qualifying company in another member state (Art. 3). However, Sweden has gone further than that and normally apply the rules on non-taxation, both as a source state and as a residence state, even if the ownership is less than ten percent.

## 2. Examples on Swedish income tax provisions affected by Brexit

With respect to residency, a British company cannot be a resident for tax purposes in Sweden, as Sweden only applies incorporation as criteria for corporate residence. But the opposite is possible, as the United Kingdom

[6] SE, The Income Tax Act [*Inkomstskattelagen*] (1999: 1229).
[7] SE, The Coupon Tax Act [*Kupongskattelagen*] (1979: 624).

also has "central management and control" as criteria for tax residence in addition to incorporation.

A *foreign legal person* is defined in Ch. 6, Sec. 8 ITA, as a foreign association that 1) can acquire rights and assume obligations, 2) can be a party before courts and authorities, and 3) the owners may not freely dispose of the assets of the association. One must assess whether the law of the other country meets these three criteria, and if so, Sweden will in its tax laws treat the foreign association as a foreign legal person.

Importantly, some foreign legal persons will qualify as a *foreign company* in Swedish tax law, Ch. 2, Sec. 5a ITA. A foreign company is a foreign legal person resident in a country which subjects the company to an effective tax rate similar to that of a Swedish company. No statutory level is set, but 10–15 percent tax rate would likely qualify. If Sweden has concluded a full tax treaty with the other country that covers this type of legal person, then it will also be considered a foreign company in applying the domestic Swedish tax rules. British companies will therefore normally be considered as foreign companies.

A foreign company, as defined, is beneficially treated, and can in many instances be part of similar transactions as a Swedish company. For instance, a foreign company can transfer its assets/liabilities from its Swedish permanent establishment to a newly established subsidiary without immediate tax consequences, just as a Swedish company is able to incorporate assets, Ch. 23 ITA.



From the viewpoint of Brexit, it means that if the Swedish provision includes foreign companies, British companies will qualify. In those cases, Brexit will have no consequences.

When Swedish income tax laws have been adjusted to EU primary law a pattern is visible. The legislator has normally gone further than necessary. For instance, the developments on deductibility of foreign losses (starting with C-446/03, Marks & Spencer) led to the introduction of a Swedish *group relief system* applicable only on foreign losses. However, the right is restricted to losses in foreign companies similar to Swedish companies that are residents in an EEA member state, Ch. 35 a, Sec. 2 ITA. This is an example of where the concept of foreign company is applied, but in a narrower sense.

Domestically, the group contribution system applies to loss offsetting within a group. It has also been called "intra-group financial transfers" (C-484/19 Lexel AB). A profitable Swedish group member can give a deductible contribution to a Swedish loss-making company. The *Swedish* parent company must hold more than 90 percent of the subsidiary for the *entire tax year* during which the group contribution is made.

These criteria would normally mean that many group structures involving foreign companies resident in an EEA member state would result in a breach of EU law (primarily the right of establishment). For instance, group contributions between two sister companies having a common British parent company would not qualify. Thus, a provision was added, Ch. 35, Sec. 2 a ITA, stating that also foreign companies resident in the EEA area qualify as a Swedish company in applying the group contribution rules, provided that the recipient of the group contribution is taxed in Sweden on the payment.

This provision saved a number of group structures involving foreign companies in other EU member states. For instance, a British company could own two Swedish companies, and the subsidiaries could offset profits and losses between themselves. Or there could be a third subsidiary resident in the United Kingdom, having a permanent establishment in Sweden. Group contributions between the permanent establishment and the Swedish subsidiaries were allowed.

A consequence of Brexit is that British companies will not qualify as a Swedish company as of 31 January 2020. As one requirement for group contributions is that the holding of qualifying companies lasts the whole tax year; a group with British companies, may, depending on the structure, lose the possibility to offset losses for 2020 (provided that the tax year for the group is the calendar year).



I will later, in part 3, give some remarks on the impact from the Brexit agreement, which provided some perhaps unexpected relief for the year 2020. Another relief can be provided by the non-discrimination article in the tax treaty between Sweden and the United Kingdom (found in Art. 22). The non-discrimination will solve some but not all of the issues for a group involving British companies. For instance, Art. 22(4) will save the situation where two Swedish companies are directly held by a UK parent company, see for instance Swedish Supreme Administrative Court case RÅ 1987. ref. 158. In another case, RÅ 1993 ref. 91 I, a group contribution was allowed, based on the non-discrimination article in a tax treaty between Sweden and the United States, from a Swedish parent company to its Swedish second tier subsidiary, despite the fact that there was an intermediary US company. However, in RÅ 1993 ref. 91 II, the situation was different with companies involved from two countries, Germany and Switzerland. The Supreme Administrative Court decided that it was not possible to apply two tax treaties simultaneously, so none of the non-discrimination clauses was applicable. From this follows that group structures must be carefully reviewed in order to make sure that the non-discrimination article applies, for instance by making sure that Swedish subsidiaries are held directly by British parents or by inserting a Swedish holding company.

Group contributions to and from a permanent establishment in Sweden will normally fall outside the non-discrimination article. The National Tax Agency refers, with respect to Art. 22(2) in the tax treaty between Sweden and the United Kingdom on non-discrimination of permanent establishments, to Para. 41 of the commentary on Art. 24 of the OECD Model Tax Treaty. Here it is stated that the equal treatment principle does not "extend to rules that take account of the relationship between an enterprise and other enterprises (e.g., rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership)" since such rules does not focus on the enterprise's own business activities. Only in a special case under the citizen article would the National Tax Agency allow group contribution from a Swedish company to a foreign company's permanent establishment in Sweden.[8]

In conclusion, the non-discrimination clause will only in limited cases be applicable, and as regards permanent establishments, it would normally not be helpful at all. Taxpayers will have to reorganise their legal structure in order for them to come under the non-discrimination article.

So far I have described a few examples on provisions adopted in Sweden to accommodate EU primary law, where British companies can no longer avail themselves of beneficial tax treatment awarded to EU companies. What happens with tax provisions that are implemented following different corporate tax directives?



In many cases, Sweden has implemented the directive making the provisions applicable to all foreign companies, without restriction. For instance, the domestic provisions adopted because of the merger tax directive are applicable to all foreign companies, whether they are resident in the European Union or not. Such a broad implementation means that in many cases it does not matter that the United Kingdom is no longer a member of the European Union. For instance, a merger between two British companies involving assets linked to a permanent establishment in Sweden can normally be done without immediate tax consequences, under the same conditions as for example a merger between two Swedish companies, Ch. 37 ITA.

An interesting effect occurs concerning foreign tax credit, as Sweden has followed Art. 10(2) of the Merger Tax Directive. Assume that a Swedish company merges into a German parent company, and the Swedish company has a permanent establishment in the United Kingdom. Prior to Brexit, Sweden would have to give a credit for the tax that would have been paid in the United Kingdom on the transfer of the permanent establishment if the United Kingdom had taxed the transfer (which it could not because of

[8] *Skatteverket Ställningstagande Dnr* 131 461482-12/111.

the Merger Tax Directive). Sweden has correctly implemented Art. 10(2) and would give a credit for the fictitious British tax conditioned on the United Kingdom being an EEA member state. Now it is not a member of the EEA anymore. In case the United Kingdom does not tax such a transfer (which I have not researched) then no credit is given.

Unclear, at least to me, is the situation where there is a cross-border merger between for instance a British and a German company involving a permanent establishment in Sweden. The Swedish tax rules apply, but is it even possible to merge cross-border? Do the corporate rules allow for that? Looking at Swedish corporate rules, a cross-border merger requires that the Swedish company merge with a company resident in another state within the EEA (Ch. 23, Sec. 36 Swedish Companies Act). A merger is therefore no longer possible between a Swedish and a British company. In other words, tax rules cover a situation that cannot take place anymore, which is nothing new (since its adoption in 1990, the Merger Tax Directive has since its adoption in 1990 covered reorganisations that were not possible to conduct under the corporate directives). I assume the same applies between Germany and the United Kingdom.

With respect to dividend distributions, the Swedish provisions for intra-corporate dividends already includes distributions to and from foreign companies, Ch. 24 ITA and the Withholding Tax Act. For non-listed shares, inbound dividends are normally exempt, and outbound dividends are exempt from the withholding tax on dividend distributions. For listed shares, there is a holding requirement of 10 percent of the voting rights. There may in a few cases be problems after Brexit, e.g., if the holding is less than ten percent of the voting rights but more than ten percent of the capital. But in the overwhelming number of cases the existing domestic provisions or the tax treaty will lead to no changes on taxation of intra-group dividends. 

Turning to taxation of individuals, there are some interesting effects also here. I will give a couple of examples. Sweden allows an individual that sells a private home to reinvest without immediate tax consequences on the profit (up to 3 million Swedish crowns) in a new home, provided that the acquired home is located within the EEA, Ch. 47, Sec. 5 ITA. It means that there are individuals who have sold private homes in Sweden and acquired a new home in the United Kingdom. After Brexit, that is not possible anymore. But what happens to those individuals that moved before Brexit? As I read the statute, there will be no immediate tax effects of Brexit, but when they sell the home they have acquired in the United Kingdom, then the deferred gain will be taxed in Sweden. From this follows that the individual must keep his or her home in the United Kingdom and not move if one wants to avoid taxation of the deferred gain.

A more drastic effect of Brexit concerns capital gains on exchange of shares. Sweden has generous provisions allowing an individual to defer gains on exchange of shares. However, the individual must be resident in an EEA state. According to Ch. 48 a, Sec. 11 ITA, as soon as the individual is no longer a resident in an EEA member state, the deferred gain is taxed. That became the situation after 31 January 2020. It should be said that Art. 13(6) of the tax treaty between Sweden and the UK complicates the legal situation, depending on whether the exchange of shares took place before or after emigration to the United Kingdom. I will not deal with these issues here.

## 3. The Brexit agreement and the year 2020

It is clear that the United Kingdom left the European Union on 31 January 2020. The tax effects resulting from income tax provisions that specifically refers to a company or an individual being a resident in EU or EEA will therefore be triggered as of that date. The Brexit agreement dealt with the conditions for the withdrawal but also regulated the transitional period until 31 December 2020.



Article 127(1) of the Brexit agreement states that "Unless otherwise provided in this Agreement, Union law shall be applicable to and in the United Kingdom during the transition period". Furthermore, under Art. 127(3), during the transition period, union law "shall produce in respect of and in the United Kingdom the same legal effects as those which it produces within the Union and its Member States and shall be interpreted and applied in accordance with the same methods and general principles as those applicable within the Union."

Union law is in Art. 2 defined to include, inter alia, the Treaty on the European Union, the Treaty on the Functioning of the European Union, the Charter of Fundamental Rights of the European Union, general principles of union law, and the acts adopted by the institutions, etc, of the Union.

Furthermore, in Art. 4 it is made clear that union law produces the same legal effects in respect of and in the United Kingdom as within the union, and that legal and natural persons can rely directly on provision providing direct effect under union law.

Thus, generally speaking, during 2020 EU primary and secondary law applied as usual. This means that in those cases where Sweden has made residence in an EU member state or in an EEA state a condition for specific beneficial tax treatment, such as deferral of capital gain in an exchange of shares or allowing a group contribution within a qualifying group of companies, then the statutory requirement is no longer fulfilled. But as the Brexit agreement provides for union law to be applicable during all of 2020, taxpayers in Sweden (and the United Kingdom) could rely on the direct effect of union law. This is the good news. However, in those cases where the statutory provisions went further than required by union law, then a taxpayer will lose some. The loss can vary, and a test of the statutory provision towards union law must be made.

## 4. Concluding remarks

The United Kingdom is the first country to leave the European Union. It would not be surprising if it happens again, that a member state for various political reasons leaves or must leave the union. The experiences from Brexit on income tax may therefore be valuable in dealing with future exits.

It is also likely that there will be new members of the European Union. As shown above, it may be problematic when a change of membership status occurs during the tax year. For many reasons, foreseeability not least, it is desirable to have new tax rules implemented at the start of a new tax year. Sweden has recognized that when it comes to new member states. In Ch. 2, Sec. 2 a ITA, it is stated that if a state becomes a member of the European Economic Area at another time than at the start of a new tax year, then that state, in applying the provisions of the Income Tax Act, will be considered a member for the full tax year. This is an important rule. It means, for instance, that Ch. 35, Sec. 2 a ITA will be applicable as of the first day of the tax year, and loss offset among members of the group can be achieved already in this first year.



Unfortunately, there is not a similar provision when a state leaves the European Union or the EEA. If there had been, the uncertainties of 2020 would not have existed and the reliance on the transitional rules in the Brexit agreement would not have been necessary.

A related conclusion is that any agreement on entering and exiting the European Union should provide for long transitional rules specifically aimed at the income tax effects.

It is also interesting to see that the often-broad implementation of EU law in Sweden has made some of the tax issues on Brexit less burdensome or even nonexistent. There is the reliance in many Swedish statutory provisions on the concept of a foreign company, which cover companies both within and outside the European Union. It makes the effects of Brexit when it comes to, for instance, cross-border dividends, many reorganizations, and other corporate situations much less negative for business.

As one of the main objectives of EU primary and secondary law is to provide for a smooth common market, and to facilitate cross-border activities, I think it is fair to argue that many of these provisions can be extended to third states. Not that I argue that EU law should be changed, that would require further deliberations, but rather that EU member states (as well as non-member states should try to facilitate company and individual cross-border activities.

Two examples. First, the above-mentioned rules for transfer of assets in Sweden between companies allows also foreign companies, as defined, to participate without immediate tax consequences as long as the assets continue to be taxable in Sweden. Second, a merger of two US companies involving a permanent establishment in Sweden will normally not trigger tax, and the cost basis of the assets are simply carried over to the surviving company.

The risks are limited using Sweden's definition of a foreign company. Either the foreign company is a resident in a country with a tax level similar to that in Sweden or there is a full tax treaty with the other country. Such a tax treaty will normally contain an exchange of information clause. If legislators are hesitant, they could consider including a requirement that there exists a provision on exchange of information.



It is also important to note that domestic tax laws in the United Kingdom and in Sweden have not been changed after Brexit. As noted above, there are criteria in the tax provisions that may no longer be fulfilled. But in order to change the laws, legislative action is needed. It remains to be seen if, for instance, the United Kingdom will change those tax laws that are implementing EU corporate tax directives. There is anyhow no immediate need for such changes as the directives normally make sense.

## Abstract

The article deals with some income tax in particular corporate income tax aspects of the United Kingdom leaving the European Union, from a Swedish perspective.

**Keywords:** corporate income tax, BREXIT