

## Client Information

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### ■ The impact of Brexit on taxes for private clients and non-profit organisations

On 29 March 2017, the United Kingdom (UK) informed the European Council of its intention to leave the European Union and started the exit process by invoking Article 50 of the EU's Lisbon Treaty. The UK had been due to depart from the EU two years later. After no agreement was reached between the EU and the UK by the first extension of the deadline, the departure date was again postponed. However, whether the EU and the deeply divided UK will come to a withdrawal agreement by 31 October 2019 is anything but certain after many failed attempts. If no agreement can be reached on a regulated withdrawal and the EU rejects a further postponement, the result will be a "hard Brexit".

The German legislature did not fail to act with regard to the forthcoming changes. For the different scenarios, laws were passed to take into account the tax problems that could arise. The Tax Accompanying Act ("*Brexit Steuerbegleitgesetz*") and the Brexit Transitional Act ("*Brexit-Übergangsgesetz*") are of particular importance.

#### The key facts:

- In the case of a hard Brexit, all tax privileges of EU membership will cease to apply for the UK in the future.
- On the other hand, even in the case of a hard Brexit, grandfathering is granted for the status quo to the benefit of the taxpayer if all tax-relevant actions are completed before Brexit. Brexit itself should not cause tax liability.
- If a withdrawal agreement is reached, there will be no relevant changes until its expiry. The UK will then be treated as a Member State for the time being.

In the following, we provide an overview of the consequences of a departure by the UK without an agreement ("hard Brexit") and in the event of an agreement ("soft Brexit").

#### A. Consequences of leaving without an agreement

##### I. UK's relapse into the status of a non-EU Member State

If an agreement is not concluded or postponement of the withdrawal fails, the UK will become a non-EU Member State after 31 October 2019. The EU fundamental freedoms and thus all tax benefits linked to a connection to the EU or the EEA will cease to apply. The above-mentioned laws do not provide provisions to mitigate these consequences, as far as transactions after Brexit are concerned.

## 1. Consequences for UK's non-profit organisations, their donors and foundations

In the past, meeting the requirements for tax exemptions in terms of Secs. 55 et seqq. German Fiscal Code, especially providing necessary evidence, was already not a straightforward matter for foreign non-profit organisations (NPO) and their donors and failed in most cases. Therefore, the practical impact of the tax consequences of a hard Brexit is likely to be limited.

Due to Brexit, NPOs from the UK that are subject to limited tax liability (in particular charities under English law) can no longer be exempted from German corporation tax. At the same time, donors can no longer deduct charitable donations from their taxable income and there is an increased risk that donations will be subject to gift taxes.

In addition, the carrying value privilege is waived when an asset is withdrawn and transferred to a charitable organisation in the UK.

**Case:** A German company decides to transfer its current PC inventory to an English NPO.

**Result:** Theoretically, before Brexit, the PCs could be withdrawn at the carrying value, provided the NPO could prove the tax exemption. Hidden reserves do not have to be taxed. At the same time, however, the value of the donation is only measured according to the carrying value (plus VAT). After Brexit, the withdrawal can only take place at partial value; deduction of donations from taxable income is not possible.

Moreover, the annual tax allowance for training leaders in the amount of EUR 2,400 and for volunteers in the amount of EUR 720 in the service of a legal person under public law or a NPO in the UK that is subject to limited corporation tax cannot be claimed.

In the case of a hard Brexit, it will be imperative for German tax-privileged corporations which support recipient organisations in the UK to embed a clause for fundraising in their statutes within the meaning of the Sec. 58 no. 1 German Fiscal Code ("*Abgabenordnung*") in order to avoid risks under charitable law. Admittedly, this has been and still is recommended for any cross-border promotion anyway.

## 2. Consequences for beneficiaries of trusts

The German Foreign Tax Act stipulates for foreign family foundations that the income of a family foundation is attributed to the founder or, alternatively, to the beneficiaries. This also applies to foreign trusts. The founder or settlor or the beneficiaries must tax this income as their own income.

The law provides for exceptions to attribution on taxation if the family foundation or trust is established in an EU or EEA Member State, if proof is provided that the foundation or trust assets are legally and actually withdrawn from the power of disposal of the founder or the beneficiaries, and information is provided in accordance with the Mutual Assistance Directive. This has been the case in the UK thus far. After a hard Brexit, it is no longer possible to provide proof for the conditions of the exception for a trust resident in the UK.

**Case:** A, domiciled in Berlin, is the beneficiary of a trust, resident in the UK, which realises dividend income from shares in UK resident companies. The settlor has already passed away. A has not yet received any distributions from the trust.

**Result:** After Brexit, the trust income – in addition to other beneficiaries, possibly only pro rata – is attributed to A on the basis of the German Foreign Tax Act, even if no distributions have been made. A must tax these amounts as his own dividend income as income from capital assets. If A later receives distributions from the trust, these are not taxable if he can prove the earlier attribution.

### 3. Exemption from inheritance and gift tax for transfers of companies

After a hard Brexit, business assets which then no longer serve a permanent establishment in an EU Member State or EEA State, as well as shares in a limited company of more than 25 % which then has its seat or management in a non-EU (and non-EEA) Member State, can no longer be exempt from tax up to 85 % or under certain conditions up to 100 %.

**Case:** Mother A, domiciled in Berlin, is the sole shareholder of a corporation resident in London. After she has passed away, her daughter inherits the shares.

**Result:** Since A was domiciled in Germany, the acquisition of the shares in the English corporation is subject to German inheritance taxation. If A passes away after a hard Brexit, the tax exemption for business assets and for shares in corporations can no longer be claimed for the shares in the English corporation.

In addition, inheritance tax on rented housing in the UK will no longer be set at 90 % but at 100 % of value. The full tax exemption of a UK family home, which exists currently under certain circumstances if a spouse or children inherit the property and continue to use it, will be abolished.

**Case:** Family A (all German citizens) has been residing exclusively in England for two years and lives there in their own family home. When the parents pass away, the single heir son stays in the family home.

**Result:** Since the family has not lived abroad for more than five years, the parents' estate is subject to German inheritance tax. The family home, which is located in a non-EU Member State after Brexit, can no longer be inherited tax-free.

Furthermore, tax exemptions currently exist for cultural goods, if they are located in the EU/EEA. This advantage will most likely end in the case of a hard Brexit.

### 4. Other regulations

Further advantageous regulations regarding the relocation of a corporation's seat to an EU Member State, taxable disjunction, the German Transformation Tax Act as well as the exit taxation under the German Foreign Tax Act, which are linked to the EU or the EEA, are no longer applicable.

## II. "Grandfathering" for the status quo when all tax-relevant actions are completed

In order to ensure that Brexit does not have any negative legal consequences for the taxpayer without his intervention, the German Tax Accompanying Act subjects already existing situations to special transitional rules. The aim is to maintain the status quo if the taxpayer has already completed all tax-relevant actions before the Brexit.

### 1. Privilege of business assets

German inheritance tax law has been amended to maintain the tax exemptions granted in the past. For example, the annual total wage bill of equity interests in partnerships or shares of more than 25 % in corporations in the UK, which were included in the initial total wage bill, can still be included despite Brexit.

This is important, as the inheritance tax exemption of business assets up to 85 % requires that the wage bill in the company does not fall below 400 % of the initial wage bill within five years of acquisition, or for complete tax exemption that the wage bill does not fall below 700 % of the initial wage bill within seven years.

Case: A, domiciled in Germany, holds 100 % of the shares of a limited liability company ("Gesellschaft mit beschränkter Haftung" = "GmbH"), B-GmbH, which holds 100 % of the shares of a subsidiary in the UK. B-GmbH has 70 employees in Germany (total wage bill EUR 3.5 million) and 30 employees in the UK (total wage bill EUR 1.5 million). After A has passed away, her daughter and sole heir T restructured the company and after two years she dismissed ten employees of B-GmbH (salary savings of EUR 0.5 million). However, ten additional employees are hired in the subsidiary (additional wage bill of EUR 0.5 million). The UK left the EU after the inheritance.

Result: As mother A was domiciled in Germany, the acquisition of the company is subject to German inheritance tax. The daughter T can claim the tax exemption for the company despite Brexit. The employees in the UK can still be taken into account when determining the minimum wage bill amount, as the inheritance tax arose with the inheritance before the Brexit. In such a case, the UK must continue to be treated as an EU Member State.

### 2. Taxable disjunction of assets

If an asset is removed from the business assets and transferred to a permanent establishment in a Member State, an adjustment item is created for the accruing profit, which can be written off over five years at an annual rate of 20 % increase in profit. However, the balancing item must be written off completely and the resulting profit must be taxed if the asset ceases to be subject to the taxation sovereignty of a Member State. Here, too, the German Tax Accompanying Act prevents the deferral from being eliminated and tax liability from being triggered solely by the UK's withdrawal from the EU.

Case: A-GmbH, based in Germany, has transferred a special crane from the German permanent establishment to the English permanent establishment. The special crane has hidden reserves of EUR 10,000. The UK then withdraws from the EU.

Result: The GmbH can post an adjustment item (EUR 8,000 in the proximate year, EUR 6,000 in the following year, etc.) and extend the taxation of hidden reserves over

five years. Brexit does not end the write-off over five years and result in immediate taxation of the profits.

### **3. Maintenance of the tax free investment reserve – no interest on tax deferral in case of reinvestments in the EU**

The advantages of a tax free investment reserve, which is intended to promote investment, are also preserved. In principle, the German Income Tax Act stipulates that the tax due on the capital gain can be paid in five equal annual instalments upon request if the hidden reserves are transferred to certain assets (e.g. land). However, interest must be paid if there is no reinvestment in business assets located in the EU/EEA. According to the German Tax Accompanying Act, no interest payment is due if an application for payment in instalments was already made before Brexit and the business assets are reinvested in the UK after Brexit.

**Case:** A-GmbH, resident in Germany, maintains permanent establishments in Germany and in England. A plot of land that has belonged to the German permanent establishment for over six years is sold at a profit. The capital gain, which is taxable in Germany, is deferred upon request. After Brexit but within the following four financial years another property is acquired in England.

**Result:** The deferral of the capital gain is not terminated by the Brexit. The deferral granted by the instalments does not have to be interest-bearing as the application was made before Brexit and the provisions of the German Tax Accompanying Act consider reinvestment in the UK to be sufficient.

### **4. No deemed dissolution and taxation in the event of departure of a corporation through transfer of management or registered office**

A further amendment of the German Corporate Income Tax Act prevents a corporation that has transferred its management or registered office to the UK in the past from becoming subject to subsequent taxation due to Brexit. In principle, a transfer of management or the registered office to a non-EU Member State results in a deemed dissolution of the corporation if the unlimited tax liability of a Member State is thereby lost. The amendment clarifies that merely the event of Brexit is not sufficient to trigger such tax liability.

**Case:** A-GmbH has relocated its management from Berlin to London. The UK then withdraws from the EU.

**Result:** Since the transfer of management took place when the UK was still a Member State, no dissolution is deemed and the hidden reserves of A-GmbH are not subject to taxation. Although Brexit is associated with the exit of the A-GmbH from unlimited tax liability in a Member State, it does not give rise to any tax liability due to the provisions of the German Tax Accompanying Act.

### **5. No subsequent exit taxation**

The German Tax Accompanying Act also prevents Brexit from triggering exit taxation on shareholdings if the departure from an EU Member State to the UK is completed. The deferral of exit taxation which was granted for departure to an EU Member State will not be revoked.

**Case:** After twelve years in Germany, A moves his domicile back to his home country England. He is the owner of various participations in domestic and foreign corporations of more than 1 %. The tax office defers the tax on departure without interest and without security. After his departure, the UK withdraws from the EU.

**Result:** Withdrawal from the EU does not constitute a reason for revoking the deferral. The exit taxation will continue to be deferred as long as A does not, for example, sell the investments or move to another third country. If A moves his residence to England after Brexit, he has to pay tax on the difference between the acquisition costs and the fair market value of the shares as a notional capital gain. If security were provided, the payment could be deferred for a period of five years if immediate payment represents a considerable hardship for A.

## 6. Other regulations

There are also amendments to the German Transformation and Corporation Tax Act to mitigate the adverse effects of Brexit on companies resident in the UK. For example, retroactive taxation of capital gains will not be triggered solely by the Brexit.

### B. Consequences of a withdrawal agreement

If the EU and the UK reach a withdrawal agreement with a transition period, the German Brexit Transition Act will enter into force. The Act will allow Germany to treat the UK as an EU Member State during the transitional period until 31 December 2020 if the withdrawal agreement is accepted. The tax privileges of EU Member States would continue to apply until then.

The German Brexit Tax Accompanying Act has already entered into force. However, the individual rules presuppose that the UK is no longer a Member State or is treated as such. Thus, the effects of the German Tax Accompanying Act would only occur at the end of the transitional period.

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