Brexit – an Impact Analysis

How Brexit may affect Indian companies established in the United Kingdom

International Business

On 23 June 2016, the UK voted to leave the European Union. Multi-nationals with a UK holding company structure or operations in the UK should therefore pre-pare for potential changes in the legal and regulatory environment post-Brexit, which may significantly impact on their busi-nesses.

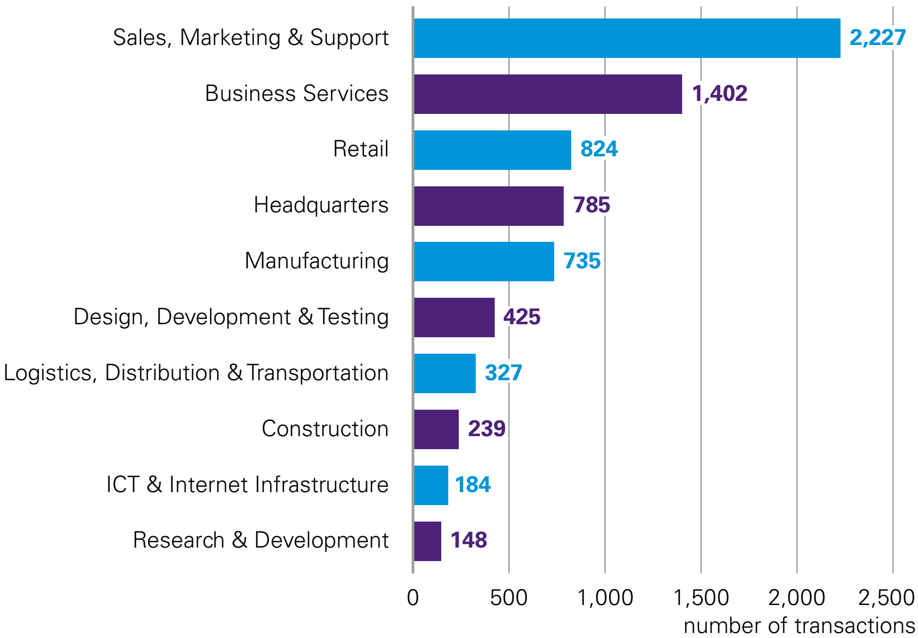
Will Brexit affect non-EU companies established in the UK?

Traditionally, the United Kingdom (UK) has been one of the most attractive destinations in the European Union (EU) for non-EU companies establishing a European holding company and operations for servicing the EU market. Of all non-EU greenfield investments in the UK since 2003, 'headquarters' have ranked fourth with 785 investments, and 'sales, marketing and support' first with 2,227 investments. Post-Brexit, the UK will no longer be a member of the EU and as such, may cause a shift in investments towards the remaining EU member states.

Today, the UK benefits from being in the EU and is often chosen by non-EU investors for its national language, English, which facilitates doing business. The UK's capital London serves as a cross-industry hub with comprehensive network infrastructure for all kinds of service providers. The anticipated departure from the EU may result in the EU regulatory environment no longer being valid and being substituted by the UK´s legal framework. This potential change may trigger additional registration obligations as well as supplementary direct and indirect taxes, such as withholding taxes on dividends, interest and royalties, and duties on imports and exports. The value-added tax (VAT) regime in the UK may also change. Restrictions on the free movement of labour combined with a changing legal environment for people-related taxes in the UK may put pressure on various industries in the UK and affect the capacity, capability and cost of required human resources.

Multinationals with a UK holding company structure and/or operations in the UK would be well advised to evaluate whether their current structure is still in line with their strategy for the European market post-Brexit.

Top 10 non-EU greenfield investments in the UK since 2003, by business activity



Source: fDi Markets, 2016

Prolonged EU exit process with undetermined outcome

Following the UK's Leave vote on 23 June 2016, UK Prime Minister Theresa May announced in October 2016 that the UK will officially apply to exit the EU no later than March 2017. According to the Treaty of Lisbon, negotiations on the future relationship between the UK and the remaining 27 EU member states could last for up to two years. The UK would therefore exit the EU no later than the first quarter of 2019. Additionally, any treaties between the EU and third countries may lose their validity for the UK and need to be renegotiated on an individual basis. The process could take several years, as has been the case with current negotiations between the EU and Canada, regarding CETA, and the US, regarding TTIP.

Although the UK government published a white paper of their Brexit strategy in February 2017, there is still great uncertainty regarding the outcome of Brexit negotiations. Three possible scenarios are summarized below. It is likely that not all of the UK government's objectives will be achieved in any of these scenarios. Consequently, compromises will have to be made, which may limit some or all of the four freedoms of movement: capital, labour, goods and services. However, this does not necessarily mean that all industry sectors would be affected negatively. It may as well be the case that some sectors benefit from increased subsidies or favourable tax regulations in the UK. Whether these changes will be moderate or far-reaching depends on the negotiations between the UK and the EU in the two-year window following the exit application.

Consequences of possible Brexit scenarios for the UK. The exact impact for non-EU companies will depend on individual facts and circumstances.

Goals of the UK government	European Economic Area (EEA) Membership	European Free Trade Association (EFTA) Membership	Independent (WTO option)
No or very few customs tariffs	🟩	🟩	🟥
Uniform regulatory framework for export-oriented companies	🟩	🟩	🟥
Free access to the integrated EU market	🟩	🟥	🟥
Access for UK-based financial institutions to EU financial passport regulations	🟩	🟥	🟥
Influence on EU regulations	🟨	🟥	🟥
Full control over UK legislation	🟥	🟨	🟩
Ability to negotiate bilateral trade agreements with third countries	🟥	🟩	🟩
No payments into the EU budget	🟥	🟥	🟩
Ability to pursue own immigration policy	🟥	🟨	🟩

🟩 Goal accomplished 🟨 Goal partly accomplished 🟥 Goal not accomplished

Source: KPMG, 2017

Potential legal issues

Even if the UK were to join the EFTA or EEA, which would oblige the UK to widely accept EU regulations, the current status of legal regulations in the UK would change post-Brexit.

Also, the UK may need to renegotiate trade and investment agreements with third parties, as treaties between the EU and these countries could expire for the UK. As bilateral trade negotiations with third parties cannot be formally concluded until the UK formally leaves the EU, companies located in the UK could be in a less favourable position compared to companies located in the remaining EU-27.

Furthermore, industries providing services or goods that fall under EU regulations, such as financial institutions, insurers, pharmaceutical companies or airlines, could be most exposed post-Brexit.

Financial institutions may be affected by the potential lack of availability of EU passport regulations. Today, financial institutions established in the UK are allowed to conduct their business in all EU countries. If EU financial passport regulations expire for the UK, and no equivalent regulation is achieved in negotiations, these institutions may need to relocate their EU headquarters or at least establish a separate legal entity in one of the remaining 27 EU member states to service the European market. Partly to this potential risk, some companies have already embarked on projects to relocate parts of their UK business to other EU countries.

Additionally, financial sourcing and clearing regulations could change for the UK and SEPA (Single Euro Payments Area) transfers could become invalid. Should financial institutions relocated from the UK to another EU-27 country, non-financial enterprises may be forced to follow suit in order to secure their financing requirements.

Pharmaceutical companies may be affected, as their operations require licences. After the UK leaving the EU, pharmaceutical companies may need two licences instead of one to sell pharmaceutical products in the EU and the UK. As the UK could define different requirements than the EU for companies to get their products licenced, licencing costs could increase significantly.

Airlines could experience significant changes since their regulatory framework, comprising international air traffic rights, passenger rights, permissions for takeoff and landing and security regulations is to a large part defined in EU regulations. It may no longer be valid and thus need to be renegotiated.

Also, EU regulations regarding data privacy and data collection may no longer be applicable for companies based in the UK. This could result, among other things, in a need to adjust data systems to the new regulations.

Finally, companies may need to apply for both UK and EU intellectual property rights for all new future patents and trademarks. Existing EU patents, however, will most likely remain valid.

Potential Impacts

- Need to comply with two different sets of regulations – one for the UK and another for the EU
- Expiry of bilateral agreements between the EU and third parties for the UK
- Different requirements for data collection and data privacy protection in the EU and the UK
- Need to apply for protection of intellectual property rights in both the EU and the UK
- Loss of EU financial passport regulations for financial institutions and insurers with EU headquarters in the UK
- Need to apply for medicine licences in both the EU and the UK
- Expiry of international air traffic rights and regulations for the UK

Potential tax-related issues

Companies operating in both the UK and the remaining 27 EU countries may face significant changes in existing tax frameworks. If the UK exits not only the EU but also the European Economic Area (EEA), many of the tax benefits conferred to EU-resident companies may no longer be available. In particular, withholding taxes for cross-border payments of dividends could increase, as the EU Parent-Subsidiary Directive would no longer apply. While this directive provides for a 0% rate on dividends throughout the EU, taxpayers would then have to rely on the bilateral tax treaties concluded between the UK and the respective EU country. These treaties, however, may provide for a minimum withholding tax rate. The same holds true for cross-border payments for royalties and interest, as the EU Interest and Royalties Directive would no longer apply. Furthermore, certain reorganizations with EU resident companies would no longer be tax free, as UK-based companies may not be able to apply for relief on such reorganizations under the EU Merger Directive.

In particular, the pooling of shares in EU subsidiaries into a UK holding in the form of a share-for-share exchange may not be tax-free, as the EU directive requires the receiving entity to be resident in the EU.

Different tax regulations in the UK and the EU could lead to an increase in administrative costs with regard to transfer pricing and multi-territorial implementation of the Base Erosion and Profit Shifting (BEPS) project.

The UK will also likely not be part of the EU VAT area post-Brexit. Companies may thus face higher compliance costs, as the UK would be treated as a non-EU country in the same way as the US and China. Moreover, certain simplification rules, such as for triangular cases in the EU, would not be applicable. Hence, companies would need to adjust processes and ERP systems to the new regulations, potentially resulting in additional costs.

Potential Impacts

- Introduction of withholding taxes on dividends, royalties and interest between the UK and the remaining 27 EU member states
- EU tax relief on certain company mergers may no longer be available to UK-based companies
- Changes in the VAT system, leading to additional compliance costs
- Additional administrative costs to adjust to new tax regulations (e.g. transfer pricing, implementation of BEPS)
- Adjustment of processes and ERP systems to new tax regulations (e.g. regarding VAT, duties and personnel-related taxes)

Potential people-related issues

The UK government has made it clear that controlling immigration is an important factor in the negotiations. Companies should therefore prepare for changes in the regulatory framework regarding their employees and in the availability of non-UK employees for their UK operations.

EU employees may need to fulfill additional regulatory obligations to secure the right to work in the UK and vice versa. Additionally, people-related taxes and national social security requirements may change for national as well as international employees in the UK.

If companies were to decide to relocate their headquarters or operations from the UK to a remaining EU-27 member state, they would also need to relocate their employees or find new workers for the future locations. In some industries such as the finance sector, many companies are expected – and some have already announced plans – to do so, as finding new employees could be costly and time-consuming.

Potential Impacts

- Need for work permits for EU employees in the UK and vice versa
- Limitation of non-UK employees for UK operations
- Changes in people-related taxes and social security requirements in the UK
- Costly and time-consuming search for new employees after relocating UK headquarters and operations
- Time pressure to finish restructuring human resources before the UK finally exits the EU

Potential trade-related issues

The day after the referendum on 23 June 2016, the British pound sterling lost around 10% of its value against the euro and remained volatile throughout the rest of the year. The resulting change in import and export prices primarily affects companies which produce in the UK and are in need of products from abroad and/or sell their products on international markets. Since the Pound is expected to remain volatile in the short to medium term, this may create enhanced currency risks for exposed businesses.

Restrictions on the cross-border movement of goods are not applicable to members of the EFTA. However, as the current political rhetoric of EU politicians suggests, the EU considers the freedom of goods, services, capital and labour as an all-or-nothing proposition. At the same time, the UK government stated that controlling immigration is an important factor. As a consequence, customs tariffs may be introduced between the EU and the UK. The same applies to international trade between the UK and third parties should EU free trade agreements expire post-Brexit. While customs tariffs are currently quite low for many industries, they can have a significant impact on companies, even if they are based on World Trade Organization (WTO) agreements.

Additionally, non-tariff trade barriers, such as packaging requirements and the need to apply for permits to sell products like medicine or food, may increase. Following Brexit, the regulatory framework for intra-EU non-tariff trade barriers could become invalid for companies located in the UK. Instead, if there is no bilateral trade agreement between the EU and the UK, national regulations of each EU member state may apply.

Unlike the goods market, restrictions on the free movement of services even apply to EFTA member countries that are not members of the EEA, such as Switzerland. As these countries accept the free movement of labour, which the UK government apparently intends to restrict, it is very likely that the UK will face similar or stronger limitations regarding services. Airlines, telecommunication companies and financial institutions with European headquarters in the UK would probably be most exposed, as they require EU licences for many of their services in order to provide them in EU countries. They would hence experience barriers and higher costs.

Potential Impacts

- Devaluation and volatility of British pound sterling
- Introduction of customs tariffs between the EU and the UK
- Introduction of customs tariffs between the UK and third countries
- Increased non-tariff trade barriers such as packaging and permit requirements in the UK
- Limitations or higher costs for companies with UK-based European headquarters when providing their services in the EU and vice versa
- Companies exporting from the UK may need to deal with 27 national trade regulations to sell their products in EU countries

The EU-27 – the second-largest market in the world

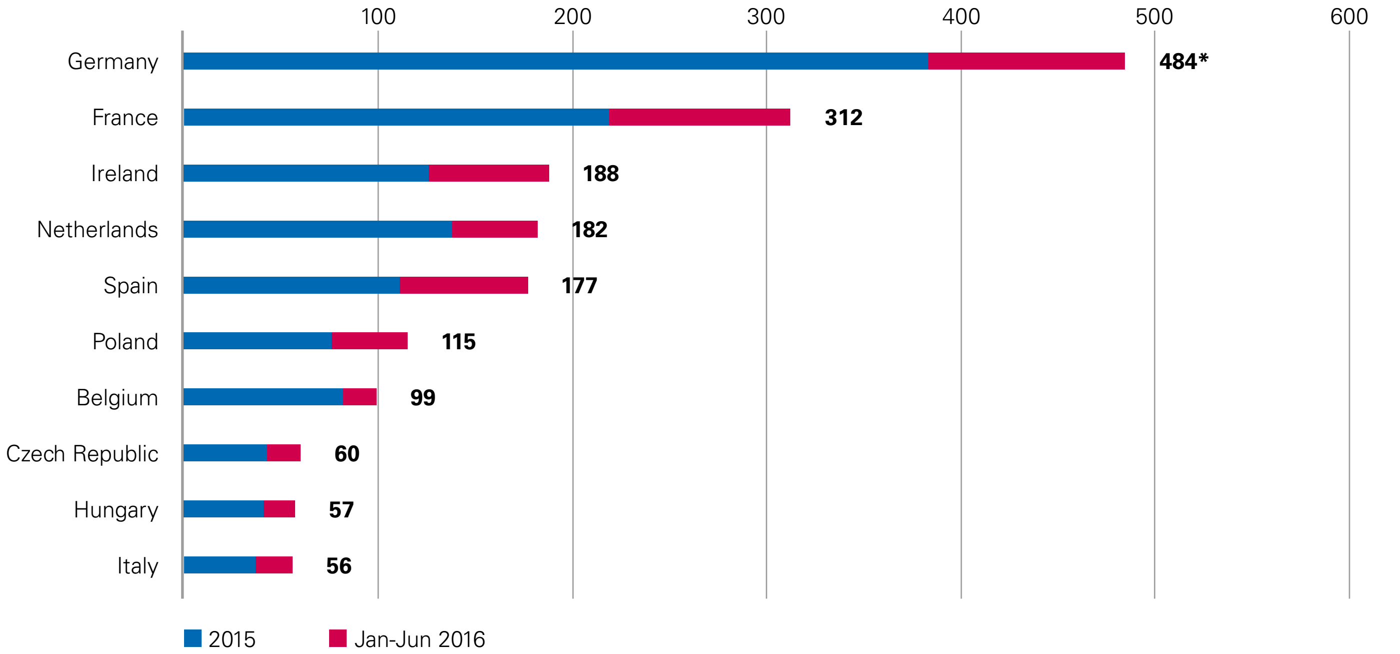
Even without the UK, the remaining 27 EU member states, home to approximately 450 million people, represent the second-largest single market in the world after the US market.

For many non-EU companies doing business in the EU, it is crucial to have a regional headquarter and/or a distribution entity in the EU. As the UK exits the single market following the Brexit referendum, companies which are currently established in the UK may have to think of relocating companies and people performing these functions to one of the remaining 27 EU member states. If not, they could miss out on the opportunities offered by the large EU market.

The decision as to which country, region and city a company's EU headquarters should be moved, depends on:

- hard and soft location factors, which differ by country (such as infrastructure, availability of well-educated employees, foreign communities, secure environment, open-mindedness of the public and the authorities to foreign investors and employees, predictability of legal decisions, etc.).
- the industry in which the company is active (e.g. in order to benefit from being established near industry clusters and being close to relevant universities).
- the specifics of the current and future operations of an organization (considering the supplier base, the size and location of the customer base, manufacturing facilities, office buildings and warehouses).

Top 10 non-EU greenfield investments into the remaining EU-27 member states



*Source: fDi Markets, 2016; *number of projects*

The case for Germany as a European destination for EU headquarters and operating companies

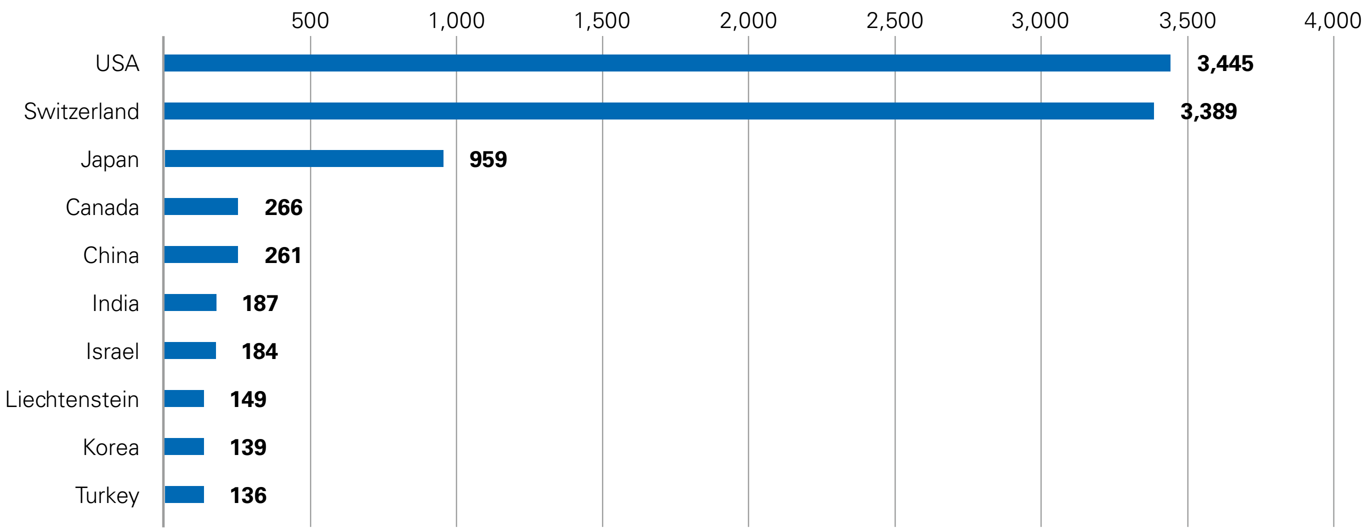
Germany is the largest domestic market in the remaining EU-27. According to the OECD, almost 27,000 foreign companies are already located in Germany – 10,800 of these firms are owned by non-EU investors. By a long way, most companies stem from the United States and Switzerland, followed by Japan.

Germany provides excellent infrastructure connections to both established Western European markets and dynamically growing Eastern European economies. Various clusters of excellence located across the country, ranging from automotive to biotechnology, make Germany attractive to enterprises from most business sectors. In addition, there are several clusters of foreign communities in Germany, such as the Japanese community in Düsseldorf, the South Korean community in Frankfurt and the US communities in Southern Germany and Frankfurt.

KPMG's *Business Destination Germany* study provides further information on Germany's appeal to international companies. Reasons include:

- strong know-how and high-tech companies, amongst others in the automotive, industrial manufacturing, chemicals and pharmaceuticals, banking and telecommunications sectors
- major country of innovations and leading patent applicant
- stable economic and political environment
- high ethical, compliance and legal standards
- high environmental and good living standard, rich culture and wide range of recreational facilities
- well-balanced academic and non-academic education system and various research institutes such as Max-Planck and Fraunhofer
- qualified, well-educated, English-speaking and highly productive workforce
- moderate unit labour costs and comparatively low strike activity
- unique family-owned business structure with more than 1,600 world market leaders
- vibrant start-up environment

Number of non-EU companies* in Germany by investor country



*Source: OECD, 2016; data from 2013; *German subsidiaries of non-German parent companies*

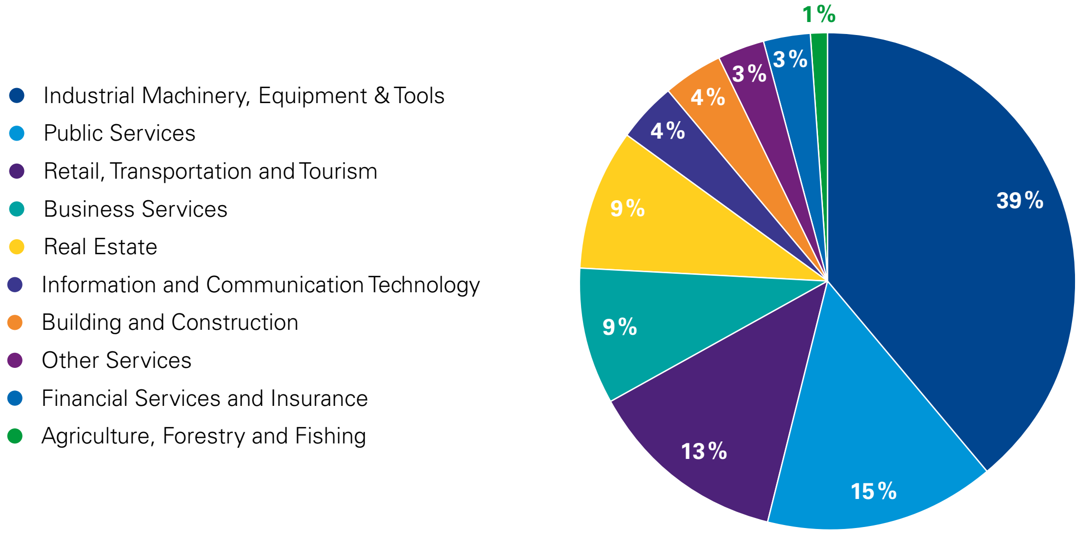
The German "Mittelstand" – a promising partner for Indian SMEs and industrial companies

It is not the large German corporates but the German SMEs or so-called "Mittelstand" which are largely responsible for the positive image that products "Made in Germany" have all over the world. More than 1,600 of these German SMEs are world market leaders in highly specialized niches (*Encyclopedia of German World Market Leaders 2015*). To do so, these companies need an infrastructure and a business environment that are adjusted to their special purposes. SMEs from India, which are currently very successful in the UK, will hence find good conditions in Germany.

Additionally, large Indian companies like Tata, Suzlon Energy and Hindalco Industries have all invested in Germany in recent years. Indian industrial companies seeking technical knowledge to push their firms to a higher level of quality will benefit from the business network that evolved around these firms.

Responsible for nearly 40% of the nation's GDP, German industrial companies are amongst world leaders in their sector. They require high-end research institutes, specialized industry clusters and high quality suppliers. The geographical position in the centre of Europe further provides short distances to European suppliers and customers.

German GDP 2015 by sector



Source: German Federal Bureau of Statistics, 2016

Relocation is complex and time-consuming

Companies should conduct a measured, thorough assessment of whether they should relocate operations to and/or replicate structures in another EU member state, including the timing of execution. For some, a sooner relocation (if at all) would be prudent, whilst for others, waiting and watching for the outcome of Brexit negotiations and the structure of a transitional agreement (if any) would be more appropriate.

Depending on the size and complexity of the business, it may take up to three years from the initial assessment to the final transfer. If a company decides to relocate operations or EU headquarters, ideally, all relocation activities should be completed before the UK officially exits the EU, which is currently expected to be no later than in the first quarter of 2019. Should the UK exit the EU before or during this period of transition, companies may be burdened with significant additional costs.

Relocation post-Brexit may be costly

As the UK will leave the EU no later than two years after drawing on Article 50 of the Treaty of Lisbon, time is of the essence.

Most importantly, EU directives that provide the legal basis for tax neutrality and cross-border reorganizations within the EU, may no longer be available. Currently, there are several ways for companies to relocate their UK holding company, for example by merging with an existing subsidiary in any of the 27 EU member states or by pooling subsidiaries into a new EU holding company by way of a share-for-share exchange. However, if the UK exits the EEA, cross-border reorganizations will no longer benefit from the respective EU directives. Moreover, expats in the UK may require visas and work permits, while additional taxes such as withholding taxes may reduce profits.

The table below indicates which further aspects need to be considered to successfully transfer European headquarters and/or operations from the UK to any of the 27 EU member states.

Feasibility of Transfer in Time	Is it possible to transfer all relevant functions, including productive assets? Can we make use of cross-border merger regulations or share-for-share exchange before the UK definitely exits the EU? If not, what are the other options for relocating European headquarters?
Legal & Tax Structure	Design a contractual basis for the transfer of headquarters and operations Consider a new corporate form Take into account exit taxes and tax losses that will be carried forward Consider loss of subsidies received in the UK and possible subsidies in Germany Adapt business to the VAT set-up change Revise the service level agreement regime and transfer pricing set-up
Human Resources	Elaborate a communication strategy to explain the transfer to present staff and increase retention Transfer employee groups to the new locations Secure required resources at the new locations (consider lead time of up to 12 months for senior hires) Secure transfer of knowledge, where present UK staff is replaced by new staff
Assets, Licences and Properties	Transfer all relevant assets, contracts and intellectual property (e.g. registered community designs and EU trademarks could lose their validity in the UK) Transfer or apply for any permits, licences or market authorisations previously granted by UK regulatory bodies to secure their validity for all EU businesses. Adopt local standards in terms of health, security and environment
Operations	Revise invoices and flow of goods Adapt IT systems to new organisational structure (e.g. ERP) and legal framework (e.g. data protection) Adopt current set-up to new local requirements (e.g. financial reporting)

Source: KPMG, 2017

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