Brexit and Cross-Border Reorganizations: German Tax Risks

by Johannes Frey, Florian Schmid, James Anderson, and Alex Jupp

Johannes Frey

Florian Schmid

James Anderson

Alex Jupp

Johannes Frey and Florian Schmid are with Skadden, Arps, Slate, Meagher & Flom LLP in Frankfurt am Main, Germany. James Anderson and Alex Jupp are with Skadden in London.

In this article, the authors examine the tax consequences of Brexit on cross-border reorganizations involving Germany and the United Kingdom. They consider whether tax-neutral reorganizations will be possible after Brexit and also evaluate the potential for retroactive taxation of some reorganizations that occurred in the past seven years.

Although the terms of Brexit remain under negotiation, it is almost inevitable that the United Kingdom will leave the European Union on March 29, 2019.

Upon leaving the EU, the four fundamental freedoms of EU primary law will cease to apply to U.K. cross-border situations — with the exception of freedom of capital since it applies to third-country relations as well — unless they are included in a transition agreement or final withdrawal agreement.[1] Other restrictions follow from the precedence of the freedom of establishment over the freedom of capital in some cases. Under EU case law, the freedom of establishment applies to holdings that give the holder a definite influence over the decisions of the company and allow the holder to determine the entity's activities — that is, a holding of at least 25 percent and, potentially, more than just 20 percent.[2] The freedom of capital provides much less protection for the taxpayer than the freedom of establishment.[3] Thus, the cross-border relations between the EU and the United Kingdom will be much less protected after Brexit.

For reorganizations, the EU merger directive (Directive 2009/133/EC) is of particular interest. The object of this directive is to avoid the imposition of tax in connection with mergers, divisions, partial divisions, transfers of assets, or exchanges of shares. The directive obliges member states to transpose its terms into national law, which the United Kingdom has done. However, after leaving the EU, the United

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[1] Christoph Bode et al., "Brexit — Tax It?" *Betriebs-Berater* 1367 (2016).

[2] *Compare Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, C-492/04 (CJEU 2007) (referencing the over 25 percent standard), *with European Commission v. Hellenic Republic*, C-244/11 (CJEU 2012) (allowing a 20 percent holding to qualify).

[3] *See, e.g.*, *Établissements Rimbaud SA v. Directeur general des impôts and Directeur des services fiscaux d'Aix-en-Provence*, C-72/09 (CJEU 2010).

Kingdom may be free to change the relevant law.[4] Further, the United Kingdom would not be within the scope of the EU merger directive unless there are transitional provisions that allow it to maintain EU rights for a defined period.[5]

From a German perspective, the merger directive can only apply to reorganizations involving companies from two or more member states. Therefore, once the United Kingdom is no longer a member state, Germany does not have to treat reorganizations involving the United Kingdom preferentially. Should the German legislature decide to adopt any mitigating legislation, this would not stem from any obligation to do so under EU law; rather, it would be a national decision that the legislature would make to reduce companies' burdens from a far-reaching and unexpected political developments.

Section I of this article begins by discussing reorganizations that, under existing legislation, will no longer receive preferential treatment after Brexit and that the parties should therefore enter into before Brexit if they intend to receive preferential treatment. Next, Section II demonstrates that some types of reorganizations will still be treated preferentially when the United Kingdom becomes a third country post-Brexit. Section III discusses reorganizations that — even if they are performed before Brexit — could lead to retroactive taxation. Finally, Section IV examines how the German legislature could provide some relief for taxpayers that are involved in reorganizations that may, from a tax standpoint, be affected by Brexit.

I. Preferred Treatment Ceasing Upon Brexit

Most types of cross-border reorganizations will not be treated beneficially under German tax law after Brexit.

A. The Reorganization Tax Act Generally

In general, reorganizations lead to a realization of built-in gains. However, since reorganizations can be economically useful and necessary, various provisions in German tax law allow for tax-neutral reorganizations. Most of these provisions are part of the German Reorganization Tax Act (Umwandlungssteuergesetz, or UmwStG). In 2006 the UmwStG implemented the EU merger directive into German law, and it has since encompassed other reorganizations within the EU.[6]

Specifically, the UmwStG applies to reorganizations if both entities involved were established under the law of an EU member state or the European Economic Area and both entities have their seat and place of management within the EU or EEA — that is, it has a two-part requirement. This dual requirement applies to mergers, spinoffs, and hive-downs (a reorganization in which a company transfers a business to a subsidiary). There are a limited set of reorganizations that need not fulfill the requirements (see Section II).

Tax neutrality — that is, nontaxation of built-in gains — is accomplished by granting the right to elect for rollover treatment of the tax book values of the affected assets (steuerliche Buchwertfortführung), thus deferring taxation of these gains until a later realization.[7] Tax neutrality is possible both for corporate income tax as well as for trade tax.

Thus, upon leaving the EU, and presuming it does not remain an EEA member state, entities that are either established in the United Kingdom or have their seat or place of management there will no longer fulfill the requirements of the UmwStG. As Section III will discuss in detail, there is also a possibility of a clawback of prior tax-neutral rollovers simply because the United Kingdom will no longer be in the EU.

B. Timing for Tax Neutrality

Timing is, therefore, critical if companies wish to benefit from tax neutrality in cross-border

[4]For more details on the application of EU tax directives post-Brexit, see Sandy Bhogal, "The Tax Consequences of Brexit," *Tax Notes Int'l*, Aug. 6, 2018, p. 599.

[5]Bode et al., *supra* note 1.

[6]Gesetz über steuerliche Begleitmassnahmen zur Einführung der Europäischen Gesellschaft und zur Änderung weiterer steuerrechtlicher Vorschriften [Statute on Accompanying Measures in Tax for the Purpose of the Introduction of the European Company and Amendments to Further Tax Law Provisions] of Dec. 7, 2006; 2006 Bundesgesetzblatt [Federal Law Gazette] 2782; and Robert Hörtnagl, "Einführung [Introduction]," in *UmwStG* (2016).

[7]Hörtnagl, *supra* note 6.

reorganizations involving a U.K. entity. Generally, any reorganization that companies undertake according to the civil law requirements before Brexit could be tax neutral.[8] Potentially, a transition period lasting through December 31, 2020, could include preferred treatment for reorganizations, but that depends on the withdrawal treaty. A subsequent Brexit will not affect the rollover treatment. Under section 2 UmwStG, most reorganizations could even have a tax effective date before the legal effective date[9] — that is, the effective date under civil law, which is typically, as with mergers under section 20 UmwStG, the date of entry into the commercial register. This retroactive fiction helps facilitate the transaction by linking the effective tax date with the closing of the German generally accepted accounting principles balance sheet. Therefore, for these reorganizations, the calendar year-end may be the effective tax date, even if the entity does not file for registration until the end of August of the following year.

However, for reorganizations that require both entities to be in the EU — such as mergers, spinoffs, and hive-downs — the question arises as to how a retroactive effective tax date would apply in light of Brexit. Is it sufficient for the reorganization to establish a retroactive tax date that falls before the United Kingdom leaves the EU, or must the civil law requirements, namely entry on the commercial register, be completed before the departure date?

Naturally, there is no German jurisprudence regarding the Brexit issue specifically. Further, the German tax authorities have not made any statements thus far, and even views in the tax literature on that specific question are rare.[10] Some experts in German tax law assert that all requirements for tax-neutral treatment under the UmwStG must be fulfilled on the date that the reorganization is effective under civil law, typically the date of registration. Under this view, the fictional effective tax date only affects the legal tax consequences — the requirements for tax neutrality must still be met as of the later, "nonfictional" date.[11] These experts hold that this rule should apply to Brexit.[12] Nevertheless, the tax authorities generally recognize reorganizations as tax neutral if they fulfill the personal requirements on the effective tax date.[13] Having an EU seat and place of management qualify as personal requirements. Based on these principles, the tax authorities would, presumably, refer to the tax effective date rather than the legal effective date for Brexit cases. However, the tax authorities have not expressed an official or unofficial view on these Brexit scenarios.

In our view, the tax authorities should extend these general principles to Brexit cases. Diverging from the regular approach would create inconsistency. Notably, in cases involving another issue that generates substantial taxpayer uncertainty — the status of a separate business unit (Teilbetrieb) — the tax authorities focus on the earlier tax effective date, which may result in a potential disadvantage for the taxpayer.[14] Since the United Kingdom's decision to leave the EU came as a surprise to companies and forces many entities to restructure to meet regulatory requirements, Brexit is not a time when the authorities should take positions that hinder reorganization. This is especially true since there remains substantial uncertainty about the future role of the United Kingdom and its relationship with the EU, as well regarding the applicable regulatory requirements. Thus, it may be reasonable for entities to wait for more details before acting, which may result in a need to conclude any reorganization post-Brexit.

Therefore, we believe that it might be possible for entities to reorganize in a tax-neutral way even after Brexit — but within the following eight months — by using a pre-Brexit effective tax date. However, to avoid any uncertainty as to tax

[8] Bode et al., *supra* note 1.

[9] *See* Bundesfinanzministerium [BFM, or Federal Ministry of Finance], Umwandlungssteuererlass [Regulations on the Reorganization Tax Act] of Nov. 11, 2011, 2011 Bundessteuerblatt I [Federal Tax Gazette I] 1314.

[10] *See, e.g.*, Judith Geyer and Robert Ullmann, "Sonderprobleme des BREXIT im Umwandlungssteuerrecht [Specific Problems Regarding BREXIT in Reorganization Tax Law]," *Finanz-Rundschau* 1069 (2017).

[11] Bode et al., *supra* note 1.

[12] Adrian Cloer and Florian Holle, "Der Brexit im Lichte des Ertragsteuerrechts [Brexit in the Light of Income Tax Law]," *Finanz-Rundschau* 1367 (2016).

[13] BFM, *supra* note 9; and Rolf Möhlenbrock, in *Körperschaftsteuer* [*Corporate Income Tax*] (Dec. 2015).

[14] *See* BFM, *supra* note 9.

treatment, it is preferable for taxpayers to ensure that they complete any reorganizations according to civil law requirements before the United Kingdom leaves the EU or to apply for a binding ruling. In our view, the general antiabuse rule under section 42 of the German fiscal code (Abgabenordnung) that might forbid purely tax-driven reorganizations should typically not apply because reorganizations involving Brexit are driven by business or legal reasons, such as the passporting requirements under banking laws.

II. Preferred Treatment Post-Brexit

For some specific types of reorganizations, there are no or only limited EU status requirements for the entities involved. Insofar as the German UmwStG is "partially globalized,"[15] these reorganizations do not need to be fulfilled pre-Brexit to accomplish tax neutrality.

A. Transfer of Assets Into a Corporation

The contribution of German-source assets — specifically, an entire business, a separate business unit, or an interest in a partnership that qualifies as a co-entrepreneurship for German tax purposes — into a corporation in return for new shares can be performed tax neutrally under section 20 UmwStG.

For these contributions to be tax neutral, only the receiving corporation must be established in and have its seat and place of management within an EU member state. The contributing entity does not have to fulfill that requirement. Crucially, this rule provides tax neutrality as long as Germany does not — even in part[16] — lose the right to tax the profits from a future sale of the received shares under section 1(4)(1)(2) UmwStG.[17]

A loss of the right to tax could arise if, under a double tax treaty, only the shareholder's state of residence could tax those sales, not Germany.[18] This would usually be the case under article 13(5) of the OECD Model Tax Convention on Income and on Capital. The Germany-U.K. double tax treaty (the treaty) follows the OECD approach, meaning that Germany would lose its taxation rights over the transferred shares. If, for example, a U.K. entity intends to transfer its German branch to a German corporation post-Brexit, the transfer and the built-in gains of the branch would be taxable because Germany would not have jurisdiction to tax a sale of the shares. In such case, only the shareholder's state of residence — that is, the residence of the entity that transferred the asset in exchange for shares — could tax those sales, not Germany.

Notably, if the shareholder is a German branch or permanent establishment, then Germany would retain its jurisdiction to tax — thus making it possible for the original transfer to be tax neutral.[19]

In sum, contributions of German-source assets by a U.K. resident entity into a German resident corporation with its seat and place of management in Germany can be tax neutral — even post-Brexit — particularly if it is a German branch or PE that receives shares in exchange for the transfer. Contributions by a German resident entity into a U.K. resident entity will lead to taxation post-Brexit because the receiving entity will not fulfill the EU requirements.

A contribution in which the contributing entity does not meet EU residency requirements — a transaction that is tax neutral in theory — can, however, become taxable in practice if Germany would not be able to tax a future sale of the relevant shares.

B. Share-for-Share Exchanges

Share-for-share exchanges under section 21 UmwStG are closely connected to the transactions discussed in the previous section. Rollover treatment is available when shares in a company are contributed in return for shares in the receiving company.

Again, the receiving company must fulfill the EU requirement. However, there are no EU residency requirements for the contributing entity. Therefore, in accordance with section

[15] Möhlenbrock, *supra* note 13.

[16] *Id*.

[17] *See* BFM, *supra* note 9 (including an example). *See also* Dirk Nitzschke, in *UmwSTG* (141st ed. 2018).

[18] Möhlenbrock, *supra* note 13; and Gerrit Frotscher, in UmwStG [*Reorganization Tax Act*] (Jan. 2018).

[19] Article 7 of the Germany-U.K. treaty; and Frotscher, *supra* note 18, at para. 149.

1(4)(1)(2) UmwStG, there is no formal limitation against the contributing company being a post-Brexit U.K. resident.[20] In a share-for-share exchange by a U.K. resident corporation, Germany would not have a taxing right under article 13(5) of the governing double tax treaty. Thus, in practice, the transaction would not be eligible for tax neutral treatment in accordance with the principles discussed in the previous subsection.

However, if a German resident company contributes shares into a U.K. resident company post-Brexit, rollover treatment would not be available. In any event, typically only 5 percent of the taxable gain on the disposal of shares would be subject to German tax.

C. Transfer of Assets Into a Partnership

Under section 24 UmwStG, a tax-neutral rollover is generally possible when an entire business, separate business unit, or interest in a commercial partnership is contributed into a commercial partnership.

There are no EU requirements for the contributing entity or for the receiving partnership.[21] Reorganizations in which a U.K. entity contributes assets into a German partnership can therefore be performed tax neutrally — even after Brexit — from a German corporate income tax and trade tax perspective.

However, under section 24(2)(1) UmwStG, entities can only elect for rollover treatment if Germany does not lose its taxation rights over the transferred assets — a requirement much like that described in Section II.A.

III. Retroactive Taxation

The final category is the most problematic from a taxpayer's perspective — that is, reorganizations performed before Brexit that could lead to retroactive taxation.

A. The General Concept

Retroactive taxation can arise when the EU residency requirements for the contributing entity[22] fail after the reorganization. In the case of contributions into another corporation, loss of EU residency within seven years from the tax effective date of the reorganization leads to taxation[23]: Section 22(1) UmwStG retroactively taxes contributions into a corporation that were previously tax neutral under section 20 UmwStG. Under section 22(2) UmwStG, the same principle applies to the exchange of shares (section 21 UmwStG) or the contribution of shares into a corporation by a natural person.

Thus, if a U.K. entity contributed assets into a German entity in the seven years before Brexit, retroactive taxation could arise upon Brexit if Germany does not have taxing jurisdiction over a later sale — that is, when the new shares issued by the German entity are not attributed to a German branch or PE.[24] This follows from the reference in section 22(1)(6)(6) UmwStG to section 1(4) UmwStG. The transfer that originally occurred between two entities that both fulfilled the EU residency requirements is now treated like a transfer in which the contributing entity fails to meet those requirements. However, transfers of assets into a partnership are not affected under section 24(5) UmwStG.

The law grants a reduction of one-seventh the amount owed for every year that passed between the reorganization and the lapse of the EU requirement. The tax is treated as part of the acquisition costs. Notably, if Brexit involves a transition period and the agreement deems U.K. entities to fulfill EU residency requirements during that period, it might have consequences for retroactive taxation.

B. Brexit: A Special Case?

One might argue that Brexit does not trigger such retroactive taxation. Some experts note that the United Kingdom leaving the EU — thus falling outside EU requirements going forward — does not result from an action of the taxpayer and, therefore, they argue that retroactive taxation

[20] *See* BFM, *supra* note 9; and Möhlenbrock, *supra* note 13.

[21] *See* Nitzschke, *supra* note 17; and Möhlenbrock, *supra* note 13.

[22] Joachim Schmitt, in *UmwStG* (7th ed. 2016).

[23] *Id.*; and Nitzschke, *supra* note 17.

[24] Geyer and Ullmann, *supra* note 10.

should not apply.[25] Yet whether the lapse of the EU requirement results from the taxpayer's actions is generally irrelevant to retroactive taxation.[26] Read literally, the provision encompasses any case in which the requirements of section 1(4) UmwStG lapse — it does not provide any exceptions.

Generally, the UmwStG follows the guiding principle that the taxation of built-in gains should not hinder or prevent reorganizations.[27] When the government extended the reach of the UmwStG to include European reorganizations in 2006, its intent was to allow such transactions while also safeguarding Germany's taxation rights and the tax base.[28] The explanatory statement accompanying the 2006 amendment states that the government intends to reduce the burden on cross-border reorganizations.

The retroactive approach in section 22 UmwStG successfully aligns both goals. On one hand, it grants rollover treatment and tax deferral. On the other hand, if Germany's tax base is reduced within the specified seven-year time period, then retroactive taxation will apply. The tax community views section 22 as a specific antiabuse rule, which stipulates a deemed tax abuse.[29] While some commentators have suggested the provision breaches EU law, specifically the merger directive, the United Kingdom will not be subject to the merger directive — or any other EU law — after Brexit.

Focusing on its application, the retroactive taxation provision intends to encompass, for example, cases in which the contributing entity transfers its seat or place of management outside the EU sometime after the initial transaction.[30] The explanatory statement specifically mentions entities transferring their seat when they move abroad and amendments to the governing double tax treaties.[31] Those occurrences are significantly different from a singular, extraordinary event like Brexit. German tax professionals are divided over how that affects the rules on retroactive taxation.[32]

In our view, Brexit cannot be seen as an event that falls within the scope of the provision. Taken literally,[33] Brexit would lead to a lapse of the requirements of section 1(4) UmwStG. However, under a teleological approach — that is, focusing instead on the law's purpose and outcomes — events that are unforeseeable from both a taxpayer's and the legislature's view should be excluded from the scope of the retroactivity provision. This is because the provision not only protects the tax base but is also a specific antiabuse rule that — as the explanatory notes confirm[34] — aligns with the merger directive. Since, for reorganizations affected by Brexit, any potential loss of tax base is not a result of any kind of abuse, the legislative intent to prevent tax-abusive actions by the taxpayer would not be given in such Brexit cases. Therefore, if retroactive taxation is applied, taxpayers might consider filing for a divergent assessment under section 163 Abgabenordnung on the grounds that this extraordinary case presents an otherwise manifestly unfair outcome.

Retroactive taxation might also raise constitutional questions. Brexit should be implemented in the form of a statute and that statute would, at least indirectly, have a retroactive effect by resulting in a lapse of the requirements of section 1(4) UmwStG. Although the formalities of implementing Brexit in both EU and domestic law are not known, we assume that

[25] Christian Herbst and Ronald Gebhardt, "Ausgewählte ertragsteuerliche Implikationen des Austritts eines Staates aus der Europäischen Union am Beispiel des Vereinigten Königreiches [Selected Implications on Income Tax of the Leaving of the European Union by a Member State at the Example of the United Kingdom]," 30 *Deutsches Steuerrecht* 1705 (2016).

[26] Bode et al., *supra* note 1.

[27] Gesetzesentwurf der Bundesregierung — Entwurf eines Gesetzes zur Änderung des Umwandlungssteuerrechts [Draft Legislation of the Federal Government — Draft Legislation on the Amendment of the Reorganization Tax Act], Bundestag-Drucksache [Gazette of the Federal Parliament] 12/7263 at 1. *See also* Hans Dehmer, "Das Umwandlungssteuergesetz 1994 [The Reorganization Tax Act 1994]," *Deutsches Steuerrecht* 1713 (1994).

[28] Hörtnagl, *supra* note 6 at 22.

[29] *Id. See also* Schmitt, *supra* note 22.

[30] Nitzschke, *supra* note 17.

[31] Entwurf eines Gesetzes über steuerliche Begleitmassnahmen zur Einführung der Europäischen Gesellschaft und zur Änderung weiterer steuerrechtlicher Vorschriften [Draft Legislation on Accompanying Measures in Tax for the Purpose of the Introduction of the European Company and Amendments to Further Tax Law Provisions], Bundestag-Drucksache 16/2710.

[32] *See* Nitzschke, *supra* note 17, at 68; and Cloer and Holle, *supra* note 12, at 925.

[33] *See also* Marcel Jordan, "Der EU-Austritt des Vereinigten Königreichts als Rechtsgrund für eine rückwirkende Einbringungsgewinnbesteuerung [The Withdrawal From the EU by the United Kingdom as Legal Basis for a Retroactive Taxation of Contributions]," 36 *Deutsches Steuerrecht* 1841 (2018).

[34] Bundestag-Drucksache 16/2710, *supra* note 31.

the German legislature will, at the very least, have to incorporate transitional EU legislation to align German and EU law. However, the German constitution only permits retroactivity in limited circumstances. The constitutional court sharply distinguishes retroactivity — that is, when a statute amends the legal consequences of a case that was closed before the new law took effect — and retrospectivity — that is, when a statute amends the legal consequences of a case that, while it started in the past, has not yet been closed.[35] Specifically addressing tax law, the court held that a statute only has a retroactive effect if it amends a tax liability that has already arisen.[36] It is difficult to apply these principles to a statute that would enshrine the United Kingdom's exit from the EU in German law. In our view, this case represents retroactivity from a constitutional standpoint: Although UmwStG grants tax deferral under the limitation of the seven-year period, the tax on reorganization arises at the end of the calendar year of the reorganization. A subsequent Brexit statute would trigger tax retroactively — the statute would cause the EU requirement to lapse under domestic law, thus affecting tax years that have already ended. Some difficulties arise from the structure of section 22, which states that taxation retroactively occurs in the tax year of the merger upon a harmful event within the seven-year period. Nevertheless, in our view, the retroactive event is the Brexit statute that changes the status of the U.K. entity and triggers taxation.

The constitutional court holds that the rule of law protects legitimate expectations from retroactive law.[37] Therefore, in general, retroactivity is illegitimate. Retrospectivity, on the other hand, is generally legitimate, unless the respective provision was unforeseeable for the taxpayer and the taxpayer's expectations are worthy of protection — that is, if the taxpayer's legitimate expectations deserve to be valued higher than the intention of the retrospective law.[38]

In our view, for reorganizations before the U.K. referendum on June 23, 2016 — or at least before the referendum's announcement on May 27, 2015 — the law should protect the expectations of taxpayers. Until that date, the outcome — a vote to leave the EU — was completely unforeseeable. However, reorganizations after the Brexit vote would not be protected because taxpayers could not reasonably have believed that the United Kingdom would stay in the EU. From a strictly formal point of view, one might even argue that reorganizations before March 30, 2017 — the date the United Kingdom invoked article 50, triggering the formal legal process — should be protected.

Unfortunately, the situation leaves taxpayers with great uncertainty on this issue. As of today, one cannot say whether tax authorities will apply section 22 to Brexit cases. If the tax authorities do apply a retroactive taxation, taxpayers should consider taking action against the resulting tax liabilities.

IV. The Possibility of Legislative Relief

The German federal government recognizes that Brexit raises unforeseeable burdens for taxpayers. Therefore, it has set up a working group to evaluate the tax implications arising from Brexit and potential legislative relief.[39]

However, thus far there has been no legislation proposed and no information about the outcome of the evaluation has been released. So taxpayers are well advised not to speculate on the availability of such relief. The fact that the other EU member states have not introduced Brexit relief at the corporate-tax level only serves to make unilateral tax relief from the German government less likely.

As for potential mitigating legislation, the German legislature could grant a temporary tax break for reorganizations triggered by Brexit, such as those fulfilled within one year of the United Kingdom leaving the EU. This would

[35] For more detail, see Johanna Hey, "National Report: Germany," in *Retroactivity and Tax Legislation* (2000).

[36] Bundesverfassungsgericht [Federal Constitutional Court] (July 7, 2010), 2 BvL 14/02, 2010 Neue Juristische Wochenschrift [NJW] 3629, at 3631 (decision).

[37] Hey, *supra* note 35.

[38] Bundesverfassungsgericht, *supra* note 36.

[39] Antwort der Bundesregierung auf eine Kleine Anfrage [Federal Government's Reply to a Parliamentary Question], Bundestag-Drucksache 19/2613.

greatly reduce uncertainty for taxpayers, as it is unclear whether they are allowed to choose a retroactive deemed tax effective date (see Section I.B). Further, the legislature could introduce provisions that refrain from applying retroactive taxation (as under Section III) to reorganizations involving the United Kingdom in the last seven years. Since Brexit is a political decision that taxpayers could not have predicted before the referendum in 2016, we believe there are strong arguments in support of mitigating burdens for taxpayers. ■