UK leaving the EU:

briefing paper on direct and indirect tax implications – June 2016

1. Summary

In the short term, the vote in favour of leaving the EU will have little, if any, immediate impact on indirect or direct taxes. The UK remains an EU Member State until a secession agreement had been concluded. The Prime Minister has announced that the timing of triggering the secession negotiations will be a matter for his successor. Few changes are likely to occur while the secession negotiations take place and the scope of future tax changes would be determined by the outcome of those negotiations.

Following secession it is possible that the UK's approach to taxation could diverge from the current position, as future governments could have additional freedom of choice.

Some of the possible models for post-EU arrangements would include continued adherence to the EU's direct tax obligations, though.

Some indirect taxes are EU taxes: principally VAT and customs duty. The UK would need to introduce its own customs duty system, although some models would allow the UK to remain in Customs Union with the EEA and EU states. VAT is already a part of UK law and would continue without the VAT Directive, subject to future changes and new legislation for some minor points. Importantly, going forward decisions on the Court of Justice of the European Union (CJEU) would no longer impact UK VAT rules.

Even without EU legal constraints, the UK is unlikely to develop wholly new tax systems. The EU direct tax restrictions are relatively minor and the focus on a territorial system of corporate tax is a model adopted by many other countries. Similarly, there is a worldwide focus on VAT systems and many emerging economies are introducing VAT. In that context, it would surely be surprising if future governments were to make fundamental system-wide changes. Nonetheless, some models will give that flexibility to future governments. More minor changes could be made more easily, of course.

2. Possible alternatives to membership of the EU

One of the key difficulties of determining the implications of leaving the EU is that there are a number of different alternatives to full EU membership. These alternatives offer different balances in terms of advantages and disadvantages. Options include:

- **Membership of the EEA – the Norway model**. Norway (as well as Iceland and Liechtenstein) is a member of the European Economic Area (EEA) but is not in the EU. The EEA model allows access to the Single Market and thus comes with many of the key obligations of EU membership, including financial contributions (c.83% of those required of full EU membership, in the case of Norway). EEA members must follow most of the rules of the Single Market, though without a vote or vetoes on how those rules are made. EEA members have to accept the free movement of people. Norway, Iceland and Liechtenstein have all chosen to join the Schengen Area.
- **Negotiated bilateral agreement** – the Switzerland model. Bilateral agreements with the EU typically offer limited access to the Single Market (i.e. some combination of tariff-free trade, specified access to the services market, and guarantees that companies operating in these markets are treated in a fair and non-discriminatory way). Bilateral agreements rarely go far in establishing a Customs Union or addressing non-tariff barriers. Switzerland's arrangements with the EU go furthest in replicating the benefits of EU membership, but bring an increased proportion of the obligations, including accepting the free movement of people, making a significant contribution to EU spending, and compliance with the majority of rules governing the Single Market.
- **Advanced Free Trade Agreement** – the Canada model. This would bring still further reduced access to the Single Market. The EU-Canada agreement does not give tariff-free access to the Single Market for all Canadian manufactured goods, does not cover a number of key sectors, and requires Canada to accept EU rules when exporting to the EU. Specifically, the Canadian agreement does not cover services, which is a key part of the UK economy.
- **WTO membership**. The World Trade Organisation sets out rules governing trade between WTO members (which include the UK). WTO rules do not include any preferential access to the Single Market, or to any of the 53 markets with which the EU has negotiated Free Trade Agreements.

3. Process for leaving the EU

Article 50 of The Consolidated Treaty on European Union provides a Member State with the right to "withdraw from the Union in accordance with its own constitutional requirements". It is up to the withdrawing state to trigger the procedure. As a matter of law, the referendum vote is advisory to the Westminster parliament.

Until agreement on secession is reached (or after two years – or longer if there is unanimous agreement of the other 27 member states to extend the period of negotiation - in the absence of agreement), EU laws, treaty obligations and access to the CJEU continue to have effect. The European Commission has reminded the UK and other EU states of this.

4. Indirect Taxes

4.1 Customs Duty

At present, Customs Duty is almost entirely governed by EU Directives and Regulations, and duty rates, etc., are set at EU level. 75% of Duty collected on imports into the UK is remitted directly to the EU.

Following secession, control of Customs Duty, and entitlement to all of the revenue generated, would revert to the UK.

That is likely to mean that, post exit, UK legislation will be needed to replace the EU Directives, Regulations and Council Decisions that currently govern Customs Duty. Whilst it is possible that the UK could enact domestic law that simply replicates the effect of the current EU provisions, the fact that the UK has raised objections to some of those provisions suggests that some changes might be made.

Duty rates that are currently under EU control will come under UK management. Whilst this could lead to changes, with UK duty rates diverging from the EU equivalents, this seems likely to be a longer term process, if it happens at all.

Customs and International trade programmes (e.g. the Authorised Economic Operator programme) are likely to continue unchanged in effect (albeit domestic legislation to implement them may be needed), as are other Customs processes – temporary importation, duty suspension, and so forth.
Perhaps the biggest Customs Duty related change that businesses are likely to see will be the recognition of trade with EU countries as imports and exports. Depending on the outcome of the secession negotiations, this may mean that duty is payable when goods move to and from EU Member States and this, and the related import and export formalities, may result in some impediment to trade as well as extra compliance costs.

The UK's rights and obligations as a member of the World Trade Organisation would continue after secession, since it is a member independently of the EU.

The UK would lose the benefit/burden of EU level trade agreements. No doubt the UK would seek to replace most, if not all, of these agreements with independently negotiated agreements. The timeframe for negotiating such new agreements is uncertain.

Among the issues to be addressed during the secession negotiations, would be how the UK deals with trade with the remaining EU Member States. Options are discussed at 2 above. It is noteworthy that the EU has entered into a Customs Union with Turkey, as well as Andorra, Monaco and San Marino.

4.2 Excise Duty

Following secession, EU level influence on Excise Duty will be released. However, since Excise Duty rates are not fully harmonised of itself (albeit that maximum and minimum rates are governed by EU guidance, as is the holding and movement of excise goods), this is unlikely to result in material changes to rates in the UK market, although some changes would be possible.

As with Customs Duty, movements of excise goods between the UK and EU Member States will be treated as imports or exports. Subject to any agreements reached during the secession negotiations, such movements are likely to be subject to different procedures (potentially involving extra compliance costs and considerations) than the current "intra-EU trading" rules.

4.3 VAT

With effect from the date of secession, taxpayers will no longer be able to rely on the "direct effect" of EU laws and the teleological approach to the interpretation of UK VAT law (which has its origins in the way that EU law is written and interpreted) may be less widely applied. The UK courts and Tribunals will revert to interpreting the UK provisions and will have far less regard to decisions emerging from the CJEU (albeit the fact that, for the foreseeable future, UK VAT law will have its roots in EU law makes it likely that the courts and tribunals will still consider existing and future CJEU case law when applying UK provisions).

The fact that the UK will no longer have to comply with EU VAT law (on rates of VAT, scope of exemptions, zero-rating, and so forth) will mean that, following secession, the UK will have more flexibility in those areas.

It is not possible to accurately forecast any possible changes but no doubt any future government will need to consider possible changes in the context of its revenue position.

In respect of day-to day VAT matters for businesses, the practicalities of cross-border transactions will change following secession. Invoicing and reporting protocols will be revised in respect of cross-border supplies as what have been intra-EU transactions ("acquisitions" and "dispatches") will become "imports" and "exports". This will have an adverse impact on reporting and on cash flow. Certain sectors will potentially see wholesale changes in respect of how they account for VAT. For example, businesses in the travel sector may no longer be required to account for VAT under the Tour Operators Margin Scheme ("TOMS"). Suppliers of B2C e-services to the remaining EU countries which have chosen to operate under the EU's "Mini One Stop Shop" will need to register in another EU state to continue participation in the scheme. The UK would probably introduce its own version for businesses selling to UK consumers. It is also unclear if other margin schemes would be retained post-secession.

In respect of TOMS the obvious approach would be to either: (a) not apply VAT to any travel services that take place outside the UK; (b) apply VAT to all outbound tourism sold by UK tour operators; or (c) develop a UK version of TOMS. Not applying VAT to outbound tourism would have obvious attractions to the travel industry but not to the Exchequer. Similarly, the concept of applying UK VAT to all outbound tourism would put up prices for consumers and thus be unwelcome to the tourism industry.

After secession, there will no doubt be disputes between taxpayers and HMRC over the VAT treatment of transactions that predate it where EU law may still be in point. However, on secession the jurisdiction of the CJEU will cease completely in relation to UK matters and so any such questions of EU law will be dealt with entirely by the UK courts.

It is also likely that, as the date of secession approaches (and bearing in mind that it generally takes in excess of 18 months for the CJEU to hear cases) the UK courts will stop referring new cases to the CJEU in any event.

Once freed from the need to comply with EU VAT law, the possibility exists that the UK could embark on a wholesale review of the scope and coverage of VAT. In theory, it could even replace it altogether, perhaps with a goods and services tax, a sales tax of some kind or even something like the UK's old purchase tax, collected at the wholesale stage. With the trend towards VAT and VAT-equivalent taxes worldwide and the importance of VAT revenues to the UK's finances, such a radical change seems highly unlikely, even in the longer term.

All changes to the UK's VAT system (some of which are described above) will, of course, require consequential changes in businesses' tax and accounting systems. Some of these changes (particularly those around trade with the remaining EU member States) are likely to be complex and time-consuming. Systems that companies invested in when they changed from paper based administrative documentation to electronic documentation will potentially become redundant. On the plus side UK businesses will presumably no longer have to file EC Sales Lists and Intrastat returns.

4.4 Capital Duty

Following secession, the UK would no longer be bound by the Capital Duty Directive and related case law.

4.5 Unaffected indirect taxes

Indirect Taxes such as Air Passenger Duty, Landfill Tax, Climate Change Levy and Aggregates Levy will not be affected directly by an exit from the EU, since they are not governed by EU law (albeit they might be affected by wider taxation reviews following Brexit and the possibility that the EU's "state aid" rules may no longer be relevant (depending on the post-EU arrangements) might also influence the direction of travel of indirect tax policies).

5. Direct tax

5.1 What is relevant EU law for direct tax

Direct tax is less likely to be directly affected by the UK's leaving the EU than many other areas. Unlike indirect taxes, direct taxes are not expressly dealt with by the EU Treaties. As many decisions of the CJEU recite, direct taxes are solely a national competency, which must be exercised in accordance with the European Treaties.

The EU Treaties authorise the Council to issue directives to approximate laws, regulations and provisions directly affecting the establishment and functioning of the internal market. All tax directives, including indirect taxes, require unanimity and there is no joint role with the European Parliament. Member States have chosen to implement a number of directives to aid intra-EU trade and investment, as well as administrative cooperation. Directives include:

- **Parent/ Subsidiary Directive**, which concerns the elimination in certain cases of withholding taxes on dividends paid to "parent companies".
- **Mergers Directive**, which concerns deferral of tax on gains that become due at company or shareholder level for certain cross-border mergers, (partial) divisions, transfers of assets and exchanges of shares taking place within the EU.
- **Interest and Royalties Directive**, which eliminates certain withholding taxes on certain interest and royalties. Note that Gibraltar, for example, relies on the direct application of the Interest & Royalties Directive, which could particularly impact on the financial services and gaming sectors.
- **Mutual Assistance Directive**, on administrative co-operation between tax authorities, now including exchange of information on savings income etc. This will include the exchange of rulings within the EU from 2017, although this is also covered by Action 5 of the G20/OECD Base Erosion & Profit Shifting project. The intra-EU exchange of country-by-country information to tax authorities is also covered although the UK has introduced its own separate law to cover this, as have many other EU Member States.
- **Recovery Assistance Directive**, on assistance in connection with recovery of tax etc.
- The forthcoming **Anti-Tax Avoidance Directive** is likely to be enacted in 2016 but takes effect only from 1 January 2019.
- Whilst not a Directive, the **Transfer Pricing Arbitration Convention** is also relevant EU law.

The four EU Treaty freedoms - freedom to provide services, free movement of people, free movement of capital and freedom of establishment - are relevant for direct tax. The CJEU adjudicates whether national law infringes any of the treaty freedoms. Certain aspects of the UK corporation tax legislation has been found to infringe the EU Treaties. In some cases, the UK legislation has been changed so that the infringement is no longer relevant. In other cases, in particular group relief for cross-border losses, the UK legislation has been changed so as to remove the infringement, but there are open challenges to the application of the legislation.

Some UK tax legislation uses the EU's recommendation concerning the definition of micro, small and medium-sized enterprises.

Some tax incentives require state aid approval from the European Commission to be lawfully offered.

5.2 What would change if the UK left the EU?

As noted above a vote in favour of exit from the EU will start a lengthy secession process and in the meantime EU laws and treaty obligations continue to have effect. Subject to that, and any transitional provisions, after the UK leaves the EU, in principle, the Directives (and EU Transfer Pricing Arbitration Convention) would no longer apply. However, the domestic legislation into which the Directives have been transposed will presumably remain on the statute books and in force unless future governments chose to repeal it. Were the UK to leave the EU but remain within the EEA it would still need to make sure domestic law continued to comply with the Treaty freedoms referred to, since they are broadly the same in the EEA Agreement as in the EU Treaties. A similar position could apply with a negotiated agreement along the lines of the Swiss-EU agreement.

Whilst the Mutual Assistance Directive and Recovery Assistance Directive would not apply if the UK left the EU, the UK, and many other countries, have signed the OECD/ Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This has similar scope to the two EU Directives, but the details are not identical.
As set out above, on secession the jurisdiction of the CJEU will cease completely in relation to UK matters. It is not clear what would happen to ongoing claims in respect of earlier years.

5.3 State Aid rules and Harmful Tax Practices

The EU Treaties' state aid provisions also can be relevant for direct tax, as seen in the Commission's recent actions. There is no current state aid finding or litigation involving UK direct tax, and even if litigation were commenced before the EU courts, it would cease on secession.

State aid provisions similar to those in the EU Treaties are included in the EEA Agreement. However, it is not yet clear that there is any EEA institution equivalent to the Commission to investigate possible infringements of the State aid provisions in the way the Commission has.

The EU has a Code of Conduct for business taxation, dating back to 1997. The EU's Code of Conduct Group was established by the Council of Ministers and mainly deals with assessing the tax measures which fall within the scope of the **Code of Conduct** for business taxation and overseeing the provision of information on those measures. The Code of Conduct is not a legally binding instrument, but its adoption requires the commitment of member states to abolish existing tax measures that constitute harmful tax competition and refrain from introducing new ones in the future.

Leaving the EU will mean that the UK would no longer remain committed to the Code of Conduct, nor fall under the remit of the Code of Conduct Group. However, the Code of Conduct Group's work overlaps to a marked extent with that of the OECD's Forum on Harmful Tax Practices, which is mandated to identify and eliminate harmful features of preferential tax regimes in OECD member countries. As an OECD member country, the UK would see little if any change in this area on exiting the EU.

5.4 Company Law and Accounting Directives

The EU has Company Law Directives and Accounting Directives, and some tax definitions rely upon Company Law and some reporting relies on Accounting Directives. The EU has a modified version of IFRS and interpretations.

As regards Company Law and Accounting Directives, and the EU's recommendation concerning the definition of micro, small and medium-sized enterprises, the definitions would presumably not change in the short term. After leaving the EU the UK could, however, change them if it wished. After leaving the EU the UK would no longer need to apply the EU-endorsed IFRS, but could use IFRS.

5.5 The tax law of other Member States

Some UK tax reliefs are offered only in relation to EU member states, for example provisions that allow businesses to restructure their operations with the EU on a tax neutral basis. In many cases, the legislation is drafted in terms that simply refer to 'member states' without naming specific jurisdictions. That means that as membership of the EU changes, whichever countries are member states at that point in time can and do benefit from the reliefs in the UK legislation. It would not be surprising to find those reliefs withdrawn, subject to the UK attaining EEA-like membership – but note that proactive steps would be required to amend l the existing UK law.

Similar EU preferential treatments are included into the legislation of other EU member states. It seems reasonable to presume that once the UK leaves the EU then the preferential treatments offered by at least some, if not all, of the other member states will fall away. Where member states have taken a similar approach to the UK – e.g. where the provisions are formulated by reference to EU membership rather than by naming individual jurisdictions – then presumably UK businesses will automatically cease to benefit from them from the moment EU membership is lost, without any action from the member states themselves.

6. Other implications likely to impact on taxes

6.1 Systems and controls

It may require considerable planning and resource to implement appropriate changes within the ERP systems and compliance processes currently used by businesses to account for VAT. For example, tax codes and client reference data may need to be thoroughly reviewed and updated and compliance procedures as well as spreadsheets or automated tools used in the tax return preparation process would need to be amended.

6.2 Restructurings

In addition, tax managers will no doubt want to participate in strategic discussions within their organisations in advance of a secession, to evaluate the potential tax impact of any proposed commercial or corporate structural changes.

Substantial corporate restructuring may necessitate a wholesale review of the business' tax operating model.

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