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Brexit: A Tax Journey Without Maps

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Thursday, June 30th, 2016

When UK voters went to the polls on 23 June 2016 and voted by a slim majority to leave the European Union, few of them had in mind the impact on taxation. Future generations are unlikely to view it kindly. Looked at from the present the dominating features are uncertainty and disruption of settled tax norms.

It is uncertain whether the UK will actually exit the EU: The legal path to the UK invoking the withdrawal procedure under Article 50 of the TFEU is not straightforward. The Government cannot simply give notice of withdrawal. Parliament must decide and legislation establishing devolved government in Scotland and Northern Ireland complied with. The bare majority of voters for withdrawal from the EU does not itself reveal fully the divisions in British society on the question. London, Scotland, the M4 Corridor and Northern Ireland all voted strongly to remain. While 60% of over 65 year olds voted to leave, 75% of under 25 year olds wish to remain.

The only legal certainty is that until article 50 is properly invoked, EU law is fully applicable and a part of UK law.

Significant uncertainty about the future comes from the lack of any plan by the Brexiteers (disparate groups with different motivations) for the UK in terms of any possible relationship between the UK and the EU when outside the Union, let alone the consequences for the tax system. The ideas they have offered have ranged from joining the EEA to a relationship modelled on that between Albania and the EU. As the UK Government did not expect Leave to be the referendum outcome, no post EU direction has been signalled. Although international tax has been high on the political agenda, it has been absent from this debate.

One week later, and the direction is far from clear, as both the governing party and the official opposition try to replace their discredited leaderships.

Direct tax

Although direct taxation is within the competence of member states, EU law has had a significant impact on the UK direct tax regime, particularly in the international area. Every aspect of the UK international corporate tax system has been shaped by the fundamental freedoms: transfer pricing and thin capitalisation, controlled foreign companies, group and consortium relief, loss relief, permanent establishment exemptions, exit tax and dividend taxation among others. Similarly, in relation to the taxation of individuals, key cross-border issues such as equal treatment of inheritance tax reliefs for agricultural property, the anti-deferral transfer of assets abroad and

taxation of gains of offshore close companies have been reformed with the fundamental freedoms in mind. The main effect of these changes has been to keep the UK tax system open and competitive by ensuring equal treatment of equivalent cross-border and domestic transactions. These areas will require legislation if the effects of EU law are to be eliminated. Most of the current international tax rules followed hard fought litigation between HMRC and multinational companies based in the UK and elsewhere who invoked on these European provisions. Will HMRC seek to reverse its losses and reintroduce discriminatory taxes?

Absent legally binding international obligations such as the EU or EEA treaties, UK direct tax policy will, as a matter of law, be able to go in any direction. In other areas where the law has not been amended, interpretation of statutes or administrative practice in conformity with EU law, has allowed the rules to remain unamended. Interpretation of tax statutes without reference to EU principles may result in different outcomes. For example will HMRC seek to apply stamp duty reserve tax charged at 1.5% on the issue of shares into depositary receipts or clearance systems, which has been ruled to be contrary to EU law but the statute never amended?

Taxpayers who have business transactions or investments between the UK and other member states will need to pay increased attention to tax treaties as they will no longer benefit from the EU tax directives – the Parent-subsidiary Directive, the Interest and Royalties Directive and the Merger Directive. This is particularly important for technology and IP related business in light of the UK government plans set out in the 2016 Finance Bill to make more royalties subject to withholding tax.

VAT

VAT will generate huge challenges from both a practical and a legal perspective. VAT is governed by EU law that is given effect in the UK by a patchwork of primary and secondary legislation, HMRC notices and the direct effect of the VAT Directives, and mostly interpreted by the European Court of Justice. While a UK VAT system will exist, exactly how it will operate, how far it may move out of alignment with the UK's closest trading partners, and what the law means, remain in the realms of speculation. HMRC Customs Information Paper 42 (2016): EU Referendum issued on 24 June 2016 says nothing more than the fact that nothing changes until article 50 is invoked.

The practical issues for anyone engaged in cross-border business will nonetheless be significant. Goods moving out of the UK to EU member states will suddenly become exports, and goods entering the UK imports subject to tax on importation and clearance through customs. In 2014, for example, the EU accounted for 44.6% of UK exports of goods and services, and 53.2% of UK imports of goods and services. Trade in goods represented close to two-thirds of all UK exports to the EU, and over three-quarters of total UK imports from the EU (Office for National Statistics). HMRC will need a vast bureaucratic establishment just to manage this.

UK business will be excluded from simplification measures such as the EU VAT "one-stop shop" which aims to remove the burden of potentially registering for VAT in the other 27 countries. The UK's technology and media sectors where even small businesses operate internationally will be affected.

Customs duties

Exporters from the UK to the EU will be liable to customs duties on goods exported to the EU unless customs and trade agreements are concluded. At the same time, the UK will not benefit

from trade agreements the EU has concluded with other countries and will have to put this in place before leaving the EU if its exporters are not to suffer the same fate on sales to the rest of the world. Since the UK has not had an independent policy on this for over 40 years, one can only speculate as to its approach.

Social Security

UK law contains no mechanism to avoid double social security charges for employees with cross-border engagements, or for their employers. Its network of bilateral social security treaties is limited and mostly old. Within the EU, Regulation 883/2004 and its predecessors establish a single contribution regime so that double contributions should not generally arise. Brexit would result in no arrangement between the UK and half of the remaining member states and a patchwork of old treaties with the others.

International Administrative Co-operation

EU law has provided one of the tightest, most well established, frameworks for co-operation between tax administrations to ensure proper compliance currently through the Directive on mutual assistance in recovery of taxes, customs and certain fees by Council Directive 2011/16/EU and the mutual assistance in the field of recovery of claims Directive 2010/24/EU and Commission Implementing Regulation (EU) No 1189/2011. Arrangements for administrative cooperation in the VAT field were set up by the Council Regulation 218/92/EC and includes the VAT Information Exchange System (VIES). HMRC will be excluded from these. While other bilateral and multilateral instruments for administrative co-operation exist in many cases, these are recent innovations and as yet untried.

The only certainty if the UK exits the EU is that British taxpayers will be deprived of their EU rights, and immense burdens placed on HMRC while denying them key instruments and long standing arrangements to ensure international compliance. What might be gained is beyond forecast.

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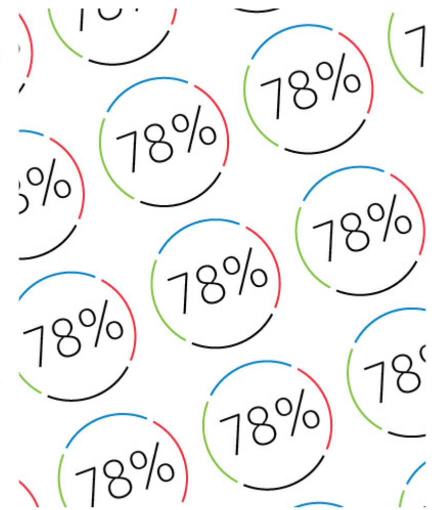

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