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Brexit: VAT's Happening?

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Much has been written – and probably even more has been said – about the different consequences of the Brexit vote. This is hardly a surprise: the decision is a first in the history of the European Union, and despite the existence of the nowadays (in?) famous Article 50, one still has trouble understanding how both the UK and EU will work their way out of the arduous negotiation that lies ahead.

From a tax viewpoint, Brexit consequences are no exception to the henceforth well-established rule of abundant literature, and Value Added Tax being an EU creature – harmonized in the different Member States – it is only fair that copious amounts of ink were devoted to the specific question of the impact of the vote on VAT. Following this trend, we will intend to expose in the next few lines the different possible scenario in the relationship between the EU and UK.

Let us first state the obvious: the UK is highly unlikely to give up VAT in itself. The tax accounted for 21% of the total tax raised by the UK Treasury in 2015[1], and appears irreplaceable for the State's budget. Replacing it by, e.g., a US-style sales tax would be an administrative nightmare for both the Treasury and businesses, and would depart from the international trend, as more than 150 States have adopted VAT as the indirect tax on consumption.

What, then, would be the different scenario on the table?

First, the UK could simply rely on its Value Added Tax Act of 1994. Having departed from the Union, the UK legislator would then be free to amend its VAT rules, to better suit its domestic and foreign policy objectives. VAT rates, for instance, could finally be reduced for feminine sanitary products, or even zeroed on domestic fuel or energy saving products. It is however likely that the divergences between the EU and UK VAT regimes would grow bigger with time, leading to issues of non-imposition or – worse – double taxation. This approach could be the source of quite a few problems for the UK and EU businesses. To name but a few – the question having been addressed at length already – (i) the benefices of the 8th Directive reclaim scheme would have to be replaced by the not-so-efficient 13th Directive paper claims, and by a domestic equivalent in the UK; a system considered to be much slower, and prone to challenges by the national authorities; (ii) disappearance of the distance selling thresholds, following which UK businesses may have to register in multiple EU Member States in order to carry on trading with EU customers, and vice-versa for the EU businesses; (iii) unavailability of the Mini-One Stop Shop (“MOSS”), therefore requiring UK businesses selling MOSS-covered products to EU consumers to register in another

EU country, and vice-versa; (iv) the application of VAT on imports and exports of goods from or to the EU, as border controls on goods would be reestablished, reminiscent of the good old times, before the establishment of the free market on 1 January 1993.

Others have discussed the negotiation of an EEA[2]-like agreement between the UK and EU. That approach is more than interesting, in that it could potentially solve one of the most significant problems ahead: that of the customs duties, at least between Members to the agreement. The UK would, however, have to make large contributions, without having a say in the adoption of rules governing the free market. More than that, the question of VAT would remain open, as the EEA Agreement does not cover tax issues, with the exception of a provision on the prohibition of discrimination.

The Swiss model appears even more unlikely. Switzerland is a Member of the Single Market by virtue of a specific bilateral treaty, as it decided at the last minute not to ratify the EEA agreement. A network of additional bilateral treaties regulates specific areas, such as free movement of persons, agriculture etc. This model, nevertheless, appears to have reached its limits as a result of the lack of integration, more importantly, again leaves aside the question of VAT. On the other hand, it offers the opportunity for the EU and the UK of cherry-picking whereby both parties can freely negotiate on specific topics (e.g. VAT).

A maybe overlooked option is the remaining of the UK within the EU VAT territory. The proposal, arguably, is an eyebrow-raiser. For indeed, the idea of leaving the EU while staying within the EU VAT territory seems, at best, contradictory. One could however think of two examples of non-EU territory included in the EU VAT territory: Monaco and, to a lesser extent, the Isle of Man.

The latter is neither an EU Member State, nor is it formally part of the UK. Its relation with the EU is governed by Article 355(5)(c) of the TFEU, and Protocol 3 to the Act of Accession, annexed to the UK Treaty of Accession to the EU. Yet, Article 7 of Directive 2006/112 specifically provides that the Isle of Man is not to be considered as a third country for VAT purposes.

More interestingly – in that it is a sovereign State, contrary to the Isle of Man –, Monaco is equally part of the EU VAT territory, without being itself Member of EU. This peculiarity finds its source in a 1963 Convention between France and the Principality of Monaco establishing a customs union between the two countries, which provides that taxes on turnover in Monaco follow the same regime as that applicable in France. Hence, and given the rules governing the treaty succession, VAT Directive 2006/112 provides that *“In view of the conventions and treaties concluded with France, [...] the Principality of Monaco shall not be regarded, for the purposes of the application of this Directive, as third countries.”*

This solution, however unusual it would be, is not technically impossible. While it is excluded that the UK would rely on a single EU Member State to find its way into the VAT territory (perhaps Scotland?), nothing precludes it, from an international law viewpoint, from negotiating its inclusion in the EU VAT territory, without being a Member State of the EU. Yet, to say that negotiating such an agreement would be a diplomatic achievement is an understatement. This is all the more true considering that both Monaco and the Isle of Man are part of the EU customs territory, a status that appears difficult to reach for the UK after the Brexit, but for the UK to secure an EEA style agreement.

This solution could however be embedded in a proposal made by different authors for a continental

partnership (CP) between the EU and the UK.

Such a CP would consist in an intergovernmental cooperation with a deep economic integration leaving aside some very sensitive topics such as the freedom of movement of workers.[3]

Arguably, the way to this final approach is strewn with pitfalls, and even the question whether staying part of the EU VAT territory would be advantageous for the UK remains to be proven. After all, would the UK agree to be subject to rules that he would not have given its input on? Would the decisions of the EU courts bind the national jurisdictions? And what about the decisions of the VAT Committee?

In the end, it seems that the most likely option is for the UK to maintain a national VAT system as close as possible to that of the EU. Mirroring to a certain extent the EU VAT rules would allow the UK to negotiate more easily the solutions to the above mentioned issues, *i.e.* the problems of VAT refund, the distance sales regime and the availability of the MOSS. However, the newfangled found freedom to adopt its own VAT policy may well be a tempting apple for London. Freed from the obligation to discuss at length the single smallest changes in the EU VAT system, the UK may well heed the sirens of the City's call and set out an advantageous VAT regime on financial services. London could indeed provide for an extended list of financial services benefiting from a VAT exemption, grant the right to deduct input VAT on these services (to the extent they would be supplied abroad), or subject them to a 0% rate...

[1] OECD revenue statistics, 2015

[2] « European Economic Area », an agreement between the EU and EFTA Member States, whereby Members of the EFTA benefit from the four freedoms of the EU single market.

[3] *Europe after Brexit : A proposal for a continental partnership*, by Jean Pisani-Ferry, Norbert Röttgen, André Sapir, Paul Tucker, Guntram B. Wolff. (<http://bruegel.org/2016/08/europe-after-brexit-a-proposal-for-a-continental-partnership>)

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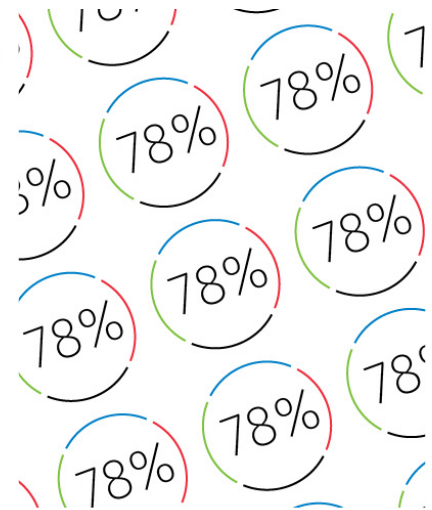
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