**Q&A**

**Brexit: the tax issues at stake**

**Speed read**

The potential implications of Brexit have been widely discussed but, due to the different alternatives for the post-Brexit relationship between the UK and EU, there remains considerable uncertainty. The tax implications could be wide, encompassing a new customs duty landscape, potential changes to the UK VAT system and the future flexibility to make changes to the UK tax code previously prohibited by EU law. Equally, little may change in practice. The implications of remaining in the EU also need to be considered, as the EU moves towards greater tax harmonisation. If Brexit does occur, businesses should contribute to the debate to shape the post-Brexit environment.

**What impact could Brexit have on taxation in the UK?**

Set out below is a summary of the main potential tax implications of Brexit.

**Customs duties**

This is the area of most immediate potential change. As a member of the EU, the UK is part of a customs union with all other EU member states. This means that goods can move to and from other EU states without either customs duties or import VAT, and without the compliance obligations associated with importing and exporting goods.

Without negotiating an alternative arrangement, Brexit would mean that the UK would be outside this customs union. Consequently, exports of goods to the EU would be subject to EU customs duties and import VAT, and imports into the UK would be subject to applicable UK duties and import VAT. The UK would also lose access to any favourable terms of export that have been negotiated between the EU and third countries.

It is, however, hoped that as part of Brexit, the UK would be able to negotiate a free trade agreement with the EU that results in no or very low levels of customs duties, mitigating the concerns above. Additionally, outside the EU the UK would be able to negotiate its own free trade agreements with third countries, potentially improving the customs position for UK trade with other important jurisdictions. However, at this stage there can be no certainty about the terms of any such new trade agreements or the amount of time it might take to reach these agreements (trade agreements being highly political and typically taking a long time to agree).

**VAT**

As an EU tax, implemented by EU member states as a condition to EU membership, the fate of VAT following Brexit has attracted a lot of attention.

Realistically, however, given the tax revenues that VAT generates for the UK (roughly a fifth of UK tax revenue), there is no practical likelihood that VAT will be abolished by the UK following Brexit. It is not even the case that it would be necessary to take significant legislative steps to preserve VAT in the UK, given that the EU VAT rules have been mainly implemented by UK legislation.

In the longer term, a UK-only VAT system, freed from the constraints of compliance with EU, might begin to diverge from the VAT system in place today. UK governments would have greater flexibility to use changes to the VAT system to...
further political objectives (e.g. by widening zero-rating, exemption rules or the use of lower rates).

Practically, for some businesses compliance obligations would be increased. This is particularly the case for businesses making supplies across Europe, which will lose the benefit of current ‘one-stop shop’ VAT arrangements and so may be required to register for VAT in multiple EU jurisdictions.

Technically, future CJEU decisions would have no authority to bind the UK courts, but it is difficult to see how they would not be taken into account by the UK courts.

In the likely scenario that little will fundamentally change with the UK VAT rules post-Brexit, a further challenge from a legal perspective would be the continuing application of the wide body of past and future decisions of the CJEU on the interpretation of VAT. Technically, future CJEU decisions would have no authority to bind the UK courts, but it is difficult to see how future decisions of the CJEU would not be taken into account by the UK courts, broadly continuing the position as it stands today.

Direct taxes
Direct taxes (such as corporation tax, income tax and capital gains tax) are a competence of individual member states and so are imposed by UK and not EU law. In theory, therefore, Brexit should have little immediate effect on direct taxation in the UK.

However, in practice, although a responsibility of member states, direct tax rules still have to comply with treaty freedoms and other relevant EU laws. Consequently, UK direct tax law is often specifically structured or drafted to comply with these rules, or it has been required to change over the years where it has been found to be non-compliant (e.g. the UK’s transfer pricing rules and certain aspects of the UK’s corporation tax group rules).

After Brexit, the EU rules may not be a consideration, potentially enabling the UK to reverse or amend previous changes made to comply with EU law and to introduce new rules that do not comply. However, the UK’s ability to make changes that conflict with EU law may be restricted under the terms of any future agreement with the EU allowing full or partial access to the single market. In any event, many of the measures previously taken to make the UK tax code comply with EU law have been business friendly measures that have opened the UK to international business and supported the UK’s position as a business friendly and attractive jurisdiction. It is unlikely that any government would want to make changes that could materially damage the attractiveness of the UK to business.

Withholding taxes
Withholding taxes on payments such as dividends, interest and royalties between the UK and EU member states may become more of an issue following Brexit, since the EU Parent-Subsidiary and Interest and Royalties Directives will cease to apply. This could make the UK a less attractive holding company location for European groups.

However, the UK’s wide network of double tax treaties should, for the most part, apply in the same manner as these directives to remove withholding taxes on such payments. The UK has double tax treaties with every other EU member.

There will however be exceptions that may result in extra costs for some businesses (e.g. dividends paid to the UK from German and Italian subsidiaries or royalties paid by a UK company to a Luxembourg company).

Transfer taxes
If the UK is outside of the EU, theoretically it would be free from the restrictions imposed by the EU Capital Duties Directive and would have the freedom to impose stamp duty on new share issues. This does, however, seem unlikely, given the potentially negative impact this would have on the UK’s position as a leading equity capital market.

The UK would also, technically, be free to ignore the ruling in HSBC Holdings plc and Bank of New York Mellon v HMRC [2012] UKFTT 163 (TC) and re-impose the 1.5% stamp duty charge on the issue of shares into depositary and clearance systems. However, this again seems unlikely.

State aid
Although of wider application than tax alone, the EU rules that seek to prevent member states from providing anti-competitive state aid to its citizens may no longer apply. In the area of tax, these rules have restricted the UK’s ability to provide tax incentives and exemptions to its citizens.

Following Brexit, the UK could potentially introduce tax rules that could give UK citizens benefits, reliefs or other advantages that could provide a competitive advantage against members of the EU. However, the reverse is also true: EU members could provide state aid to their citizens to the detriment of UK citizens.

In any event, rules on state aid would most likely be a key part of any future agreement between the UK and the EU (as they are in the EEA agreement), so it seems unlikely that there will be no state aid restrictions in a post-Brexit environment. Further, harmful tax competition between jurisdictions is also a key target of the OECD BEPS project. The UK is taking a leading role in this, making it even more unlikely that the UK would take steps post-Brexit to provide material state aid.

Merger Directive
The Merger Directive is designed to provide relief for cross-border reorganisations between companies operating in the EU. It allows companies to defer taxes that would otherwise be payable on a reorganisation. The consequences of Brexit would mean that this Directive would no longer apply to such cross-border reorganisations involving UK companies. UK legislation enshrines the Directive’s requirements and would not be affected by Brexit, but future changes contrary to the Directive could then be made.

Social security contributions
Currently, UK workers who are employed to work in another EU member state are, pursuant to EU rules on social security contributions, only required to pay social security contributions in one member state, avoiding potential double contributions. These rules would not apply following Brexit, potentially causing uncertainty and additional cost for businesses with an internationally mobile workforce, unless a similar arrangement can be reached between the UK and the EU.

When might any changes occur?
Assuming that on 23 June the UK votes for Brexit, there will be no overnight change to the UK tax system. After the vote, there would be a period of approximately two years for the UK and EU to negotiate the terms of exit. This period could
even be extended further if no agreement can be reached and the EU member states agree to such an extension. Throughout this period, EU law would continue to apply and, therefore, little can be expected to change quickly, although there will be great uncertainty about what will follow.

After this period, there is really no way to predict if or when any changes may occur. For example, some of the potential tax advantages of Brexit (such as preferential rates of customs duties with third countries) will flow from renegotiated trade agreements. These can take many years to negotiate, agree and implement. Other changes will be driven by future political and economic requirements that are impossible to predict at this stage.

A vote to remain is not necessarily, however, a vote to retain the status quo from a tax perspective, with the EU becoming increasingly active on tax issues beyond VAT and customs duties

How might multinationals operating in the UK be affected?
Multinational businesses with a presence both in the UK and Europe, especially manufacturing and retail businesses, are particularly likely to be impacted by some of the more immediate implications of Brexit.

For example, the future customs union position will be key. Significant additional duty and compliance costs could arise for such businesses, if appropriate post-Brexit agreements are not reached with the EU. Equally, in the longer term such businesses might benefit from any better international trade terms the UK is able to agree independently from the EU.

From a VAT perspective, compliance costs may rise for UK businesses operating in the EU; for example, due to obligations to register and account for VAT in multiple EU member states. Withholding taxes on intra-group payments between UK and EU group members will also need to be considered, should the Parent/Subsidiary and Interest and Royalties Directives cease to be applicable. Relevant double taxation treaties will need to be assessed to check the position and, even where withholding taxes are removed, there may be different compliance or filing obligations applicable (with associated cost consequences).

More generally, one of the reasons the UK has to date been an attractive holding or headquarters jurisdiction for European-wide businesses has been access to EU laws that are broadly business friendly and designed to promote a free market within the EU. The loss of these protective rules (for example, state aid and the fundamental freedoms), both from a tax perspective but also generally, may put multinationals operating from the UK at a disadvantage to those centralised within the EU. Coupled with the issues identified above, this may cause some UK headquartered multinationals to consider restructuring their European businesses to mitigate any such disadvantages of Brexit.

How can businesses plan ahead for Brexit?
In practice, most businesses can do little at this stage to plan for a potential Brexit, beyond developing a general understanding of the issues and areas of possible change. Too much is uncertain at this point (and will be for a considerable period beyond any Brexit vote) for most businesses to sensibly undertake contingency planning before the vote. However, for some businesses there may be a greater obvious impact of Brexit (perhaps tied to wider issues such as regulatory concerns) that mean more detailed contingency planning is required.

In the immediate aftermath of a vote for Brexit, there will inevitably be a considerable amount of analysis and debate politically and within the business community as to the form of Brexit. At this time, it is recommended that businesses consider the main alternatives and the high level impact of these alternatives, focusing on key issues and the most likely areas of change. Armed with this information, businesses can then potentially seek to contribute to and influence the Brexit debate.

What might be the tax consequences of remaining in the EU?
Alongside a consideration of the tax implications of Brexit, it is important also to consider the tax consequences of a vote to remain within the EU. A vote to remain is not necessarily, however, a vote to retain the status quo from a tax perspective, with the EU becoming increasingly active on tax issues beyond VAT and customs duties.

In recent years, mirroring the work of the OECD, the EU has been seeking to use or extend its powers to tackle corporate tax base erosion and profit shifting. This is evidenced by the recent release of a draft Directive on anti-avoidance, which seeks to use the legal framework of the EU to enforce the OECD BEPS recommendations. Alongside this, the EU is also attempting to revamp its proposal to create a common consolidated corporate tax base (CCCTB) within the EU.

Both of these measures seek a greater degree of tax harmonisation with the EU and are likely to be indicative of a developing and potentially inevitable trend towards greater tax harmonisation within the EU. Alongside these measures, we have recently seen much greater activism by the European Commission in the area of state aid and tax, with challenges to tax authority rulings anticipated to continue and then be extended into other tax areas such as tax settlements.

We have also recently seen the EU attempt to impose tax policy on member states through the EU-wide adoption of a financial transactions tax (FTT).

To date, tax harmonisation attempts, such as the FTT and the CCCTB, have foundered due to issues of tax sovereignty and the legal requirement within the EU to obtain unanimous member state agreement for such changes. The UK has always been vocal and resistant on issues of tax sovereignty. However, given the UK’s lead role within the OECD BEPS project and its early adoption of many of the BEPS recommendations, it would be more difficult for the UK to resist equivalent EU-wide measures. Accepting these measures could be the first steps along a path to greater tax harmonisation.

Final thoughts?
The conclusion is that no conclusions can be drawn at this stage. The best that can be achieved is that the UK is well informed of the potential implications of Brexit before voting. In the event of a vote for Brexit, plans can begin to be formulated for the changes that will eventually follow.

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- The public finances and the Brexit vote (David Smith, 2.6.16)
- Brexit: UK tax policy considerations (Hilary Barclay, 9.3.16)
- Brexit: VAT and customs duty considerations (Julie Park, 9.3.16)