Brexit Referendum: The Tax Implications

Britain's decision to exit the European Union will inevitably bring significant changes, particularly so in relation to taxation.

Although the UK electorate's decision is known, the tax implications arising from the '52% Leave 48% stay' referendum on June 23rd 2016 will not be known until the UK's Government invokes Article 50 of the Treaty on European Union (TEU).

In the weeks post-June 23rd, there has been clamor, debate, puzzlement, confusion, and uncertainty amongst UK citizens and politicians alike. However, despite street marches in London, threats of legal challenges to the validity of the result, calls and petitions on the British Parliament to vote against the new bill to repeal the 1972 European Communities Act that took Britain into the EU in the first place, it is becoming more and more certain that the British government will honor the wishes of the majority and will sever its membership ties with the EU.

This has been echoed by Britain's new Prime Minister, Theresa May who although pre-referendum day, voiced her support for Britain to remain in the EU, and she has since stated clearly and publicly that "Brexit means Brexit". This stance has been reinforced by the creation of a new Government department with specific responsibility delivering Britain's exit. The candidly titled 'Department for Exiting the EU', headed by longstanding Eurosceptic MP, David Davis as 'Secretary of State for Exiting the European Union', serve to reinforce the message to UK Remain supporters and EU leaders alike, that Britain's direction of travel on the matter is in no doubt.

Presently, no immediate changes have been triggered and the UK will continue to be engaged in EU Zone decision-making, just as it did prior to its decision to leave. Triggering Article 50 of the Treaty of Lisbon, formally notifying the EU of Britain's intention to withdraw from the 28 member block, will officially kick-off the process. On the morning after his appointment as Secretary of State, Mr. Davis announced that Article 50 should be "triggered before or by the beginning of next year".

Once triggered, the Treaties that govern EU membership will no longer apply to Britain. The terms of exit will be negotiated by EU member states and each will have a veto over the conditions. At the point at which Article 50 is invoked, the UK will continue to be bound by all EU laws, up to and until the terms of the exit have been agreed. However, once Article 50 is invoked, the UK's participation in any and all ongoing and future EU decision making will cease.

Precedent

The formal exit process is supposed to take two years but the widely held belief is that it will take considerably longer. Michael Dougan, Professor of European Law at the University of Liverpool, believes the entire process could take-up to 10 years to complete. There are no comparable precedents to guide us here though Greenland's experience provides some tenuous insight, not part of Europe but ruled by Denmark, joined the EU at the same time as the UK in 1973 but a decade later 53% of Greenlanders voted to leave. The problem was fishing. Greenland's trawler men were already under pressure from foreign boats using their rights under the Common Fisheries Policy, and the giant fleets of Spain and Portugal were about to join in the free-for-all, so voted that enough was enough.

There are not many similarities between Greenland and the UK. Greenland has a population of 56,000 people with an economy dominated (90%) by a single industry, fishing. As such, Greenland is neither a major export market nor a destination state for any EU member countries or its citizens.

However, what is interesting nevertheless, is that even for Greenland, untangling itself from EU membership was a long and laborious process. It took more than 3 years to do so, even though there was just one industry and one product involved. Regardless, their trade relationship with the EU had to be re-negotiated. They succeeded though it can be argued that Greenland was economically small enough for Brussels to have been magnanimous on its exit penalties. Today, Greenland is still ruled by the Danish crown, its people remain EU citizens and the EU still provides substantial funds in return for access to some of Greenland's fishing territories.

However, they are no longer at the EU table when fisheries are discussed, but in order to sell into the single-market – which they must – every rule applies to them as much as it does to EU members. For the UK, it could very well be a case of being able to check-out at any time but never being able to leave.

Tax Implications of Brexit

Though not immediate, the tax effects will eventually be significant with the most significant impact expected to be on indirect taxes, including;

• Value Added Tax (VAT)
• Customs Duties
• Excise Duties
• Corporation Tax
• Transfer Pricing
• Primary EU Law, European Court of Justice Case Law and State Aid
• The European Medical Agency (EMA)

Impact on Value Added Tax (VAT)

VAT has been undergoing harmonization within the EU since 1977 as different VAT systems within the Union represented a major impediment to free trade and the creation of a truly common market.

Today, EU member states must apply a 'standard' VAT rate of at least 15%. Currently EU country has a standard rate below this minimum. There are no restrictions on a maximum VAT rate exemplified by Hungary, whose stands VAT rate is 27%, compared to 19% in Germany and 20% in the UK.

Britain's exit from the EU will enable it to redesign its entire VAT system, even to the point of abolishing VAT altogether, if it so desired. With no EU VAT Directive or European Court of Justice rules, the latitude to do so would exist. However, with VAT collections accounting for 17% of all UK Government's receipts, it is highly unlikely that VAT would be abolished across the board or that the range of goods and services currently benefitting from reduced or nil rates of VAT eg; home energy and children's clothing would be substantially increased. In fact, if the UK Government were to tinker with VAT rates, in certain aspects, or reasons of political gain, it is likely that rates would be altered downwards rather than upwards on certain items. Abolishing VAT on home energy supply was one of the Brexit 'promises' put forward by the Vote Leave campaign in the run-up to the June 23rd Referendum day.

Import VAT

At its official date of exit from the EU, Britain's trade with EU Member States have the status of a non-Member State. Currently, VAT on intra-EU acquisitions is normally reported on the acquirer's UK VAT return – as both output tax and input tax – while VAT on imports is usually paid immediately once goods have cleared or deferred under a duty and VAT deferment system.

A consequence of exiting the European Union is that import VAT will be charged on imports from other EU Member States into the UK. The same principle would apply to goods entering the EU from the UK. In such instance, VAT might often be recoverable, however, many businesses would most certainly experience cashflow issues due to the lag between the moment of importation and the recovery of the VAT element.

While sweeping changes to the UK VAT system are unlikely, in the short term, UK registered businesses trading with EU Member States are likely to experience increased compliance costs.

Customs Duties

The EU functions as a customs union, applying common tariffs to imports from non-EU Member States and no customs duties to transfers of goods between Member States. An exit from the EU would most likely result in an exit from the customs union. This would imply the imposition of customs duties to exports made by the UK to other EU Member States, as the goods would be subject to import duties upon entry in the EU. This would lead to an increased cost for exporters of UK goods to EU Member States. A rise in costs may significantly impact UK trading, given that about half of UK exports are currently made to EU Member States. However, in many cases, the level of customs duties to be imposed post-exit is expected to be low, as tariffs are regulated internationally by the World Trade Organisation (WTO). Therefore, upon formal exit, in the absence of a special agreement between the EU, imports from the UK into the EU would be subject to the WTO's most favored nation's duties status.

The UK would be in a position to draft new legislation on customs duties to replace currently applicable directives, regulations and Council decisions and to negotiate trade agreements with other countries and trade blocs such as the Commonwealth and the NAFTA bloc. Furthermore, depending on the terms of the negotiated exit, the UK might also enter into a free trade agreement with the European Union providing for zero or very low customs duties.

Excise Duties

Excise Duties are not fully harmonized at the EU level. Therefore, existing the EU does not imply any major changes to UK rules applicable in this aspect. It means the UK will not be bound by the agreed minimum rates or by any further EU decisions in relation to Excise Duty. Excise goods transferred from or to the UK would no longer be subject to intra-EU trading rules but would be treated as non-Member State exports or imports.

Corporation Tax

Although direct taxation is not not harmonized, the EU Member States have to exercise their powers in conformity with EU Law. The European Union has several tax directives to facilitate the free movement of goods, capital services and persons. Once Britain exits, the UK will no longer be bound by these directives. However, it also means that UK companies will not be able to benefit from them either. In practice this would mean that the following tax directives would cease to apply in the UK:

o Parent-Subsidiary Directive:

The Parent-Subsidiary Directive eliminates juridical double taxation – by not allowing the source State to impose withholding tax on dividends – and economic double taxation – by requiring the residence state either exempts dividends received or granting a credit for corporate taxes paid on profits in the subsidiary State. The UK does not impose a withholding tax on outbound dividends. The effect of the directive being no longer in place may result in double taxation and it may therefore hinder foreign investment in the UK. Many EU Member States limit the domestic participation exemption to EU/EEA Member States. If an investor is faced with a tax charge i.e. dividends received from the UK are taxed in his / her residence State, he is likely to give up his / her participation in the UK entity

o Interest and Royalties Directive:

Interest and royalties paid by a company in the UK to associated companies in other EU Member States would become subject to a 20% domestic withholding tax – unless an applicable tax treaty provides for a lower rate – instead of the tax exemption provided under the directive. Intra-group financing might become more expensive or result in double taxation

o Merger Directive:

There would no longer be guarantees that corporate reorganizations such as mergers, divisions, partial divisions, transfers of assets, exchanges of shares and transfers of the registered office on an SE of SCE between EU Member States could be carried out without immediate direct tax consequences for the companies and their shareholders participating in the reorganization. Unrealized capital gains could be taxed without any deferral and the carry-over of provisions and reserves and the takeover of losses would no longer be available.

With regards to inbound situations i.e. payments made to UK recipients, many EU Member States provide under their domestic law, a reduced tax rate on dividends and interest, provided the recipient of the income resides in an EU Member State. The reduction is usually significant. For example, the dividends from Italy received by a UK corporate entity are subject to withholding tax at a rate of only 1.375% (instead of the 15% rate for portfolio investments, the 5% (for substantial ownership) treaty rate or, in cases where the treaty benefits are not available, the 26% domestic rate. Some withholding tax reductions are also made dependent on whether the Mutual Assistance Directive on administrative cooperation in the field of taxation, providing for, inter alia, exchange of information, applies. This directive covers an extensive list of income types for which information is exchanges and together with the Recovery Directive, has created an efficient toolbox to cover tax claims between Member States. After formal Brexit, the UK would no longer be able to receive such information or recover tax claims from other EU Member States.

Transfer Pricing

The UK is party to the Arbitration Convention (90/436) which provides that, if the commercial or financial relations between two associated companies differ from those which would apply between independent companies, the profits of those enterprises should each be adjusted as appropriate to reflect the arm's length position. The convention provides for disputes with fiscal authorities to be referred to an advisory commission, subject to waiver rights of appeal under domestic law provisions. In the wake of Brexit, the issue is whether double taxation in connection with the adjustment of profits of associated companies would still be eliminated.

Primary EU Law, European Court of Justice Case Law and State Aid

There is no harmonization of direct taxation within the European Union. However, Member States must comply with the Treaty on the Functioning of the European Union (TFEU) provisions on free movement of goods, persons, services and capital (the fundamental freedoms). The European Commission and the ECJ have an active role in addressing domestic legislation which might contravene the fundamental freedoms or which might constitute State Aid.

In many judgements, the ECJ has ruled that domestic provisions of a Member State do not comply with the fundamental freedoms. In these cases, Member States must change the provisions that are not in line with EU Law. As a result of Brexit (and if the UK does not negotiate a position similar to the EEA States), the UK would not be bound by ECJ case law and for the future, would not be bound to comply with the fundamental freedoms.

The United Kingdom would also be free to decide to reintroduce domestic rules which were in the past deemed incompatible with EU law.

Doubts might also arise in the future in relation to the value of UK court decisions based on EU law.

Among the four fundamental freedoms, only the free movement of capital applies in relations with non-Member States.

In November 1988, the European Commission adopted a communication on acceptable State Aid in the field of direct business taxation. Accordingly, if a Member State has already applied a specific tax measure without the consent of the Commission, the Member State may be required to recover from the taxpayer, the difference between the tax payable under the general rules and the tax actually paid. More recently, with regards to tax rulings on transfer pricing arrangements given to some multinationals, the European Commission decided that some cases constituted State Aid and ordered repayment of the aid received. Following Brexit, the UK would no longer be bound by the State Aid rules and could adopt more favorable regimes to encourage inbound investments. However, at the same time, residents of the UK investing abroad would not be protected by the EU rules against State Aid regimes in other Member States.

Brexit Impact on The European Medical Agency (EMA)

On 6 July 2016, the EMA issued a statement acknowledging the UK's decision to leave the EU following the referendum on EU membership held on 23 June 2016. The EMA underlines that "its procedures and work streams are not affected by the outcome of the referendum" and that it will "continue its operations as usual, in accordance with the timelines set by its rules and regulations".

The EMA, which is based in London, also highlighted that the impact of the referendum result on its seat and operations will depend on the future relationship between the UK and the EU. The press release goes on to state that while the EMA appreciates offers from member states to host the EMA, the "decision on the seat of the Agency will however not be taken by EMA, but will be decided by common agreement among the representatives of the member states".

The EMA will share further "concrete" information with its stakeholders as soon as it becomes available.

To further discuss the ramifications of Brexit, contact Sean M. King at sking@alignglobalconsulting.com.

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