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Brexit referendum: tax implications of leave vote

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Abstract

On 23 June 2016, UK voters decided to opt out of the European Union. The Brexit will have significant tax consequences. This paper provides some brief technical background, listing the main headings of tax law under which the Brexit will impact the United Kingdom and the European Union.

Introduction

Although the results of the exit referendum have been confirmed, the tax implications arising from the United Kingdom leaving the European Union will not be known until the United Kingdom invokes article 50 of the Treaty on European Union (TEU). Thus, no immediate changes are triggered in terms of the transactions carried out between the United Kingdom and the other EU Member States; the United Kingdom will continue to be engaged in decision making at the EU level as before. Even once article 50 is invoked, the United Kingdom will still be bound by all EU law up to the moment that the terms of the exit have been established; however, it will not be involved in decision making during that time. Article 50 provides for a period of at least 2 years between the moment that article 50 is invoked and the actual exit from the European Union. However, even though not immediate, the tax effects that an exit will have are expected to be significant.

The most significant impact of the Brexit is expected to be on indirect taxes, as these are already harmonized at the EU level. Other areas of discussion are primary EU Law, ECJ case law and State aid, corporate tax directives, and transfer pricing, social security and administrative matters. Tax implications in these areas are summarized below.

Indirect taxes

Upon exiting the European Union, major consequences are expected for the United Kingdom in the area of indirect taxes, as within the fields of customs duties, VAT and, to a lesser extent, excise duties, the European Union has achieved a high level of harmonization.

Customs duties: The European Union functions as a customs union, applying common tariffs to imports from non-Member States and no customs duties to transfers of goods between Member States. An exit from the European Union would most likely result in an exit from the customs union. This would imply the imposition of customs duties to exports made by the United Kingdom to the other EU Member States, as the goods would be subject to importation duties upon entry into the European Union. This would lead to an increased cost for exporters of UK goods to other Member States. A raise in costs may significantly impact UK trading, given that about half of UK exports are made to other EU Member States.¹ 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

¹ For details, see https://www.uktradeinfo.com/Statistics/OverseasTradeStatistics/Pages/EU_and_Non-EU_Data.aspx.

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Organization (WTO). Thus, upon exit, in the absence of a special agreement with the European Union, imports from the United Kingdom into the European Union would be subject to the WTO's most favoured nation's duties.

The United Kingdom 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 (e.g. the Commonwealth and the NAFTA bloc). Moreover, depending on the terms of the negotiated exit, the United Kingdom might also enter into a free trade agreement with the European Union providing for nil or very low customs duties.

- ▶ **VAT:** The VAT system has been undergoing harmonization within the European Union since 1977, as different VAT systems within the Union represented a major impediment to free trade and the creation of a truly common market. As such, the UK VAT system as it stands today has its roots in the EU system. An exit of the United Kingdom from the European Union would allow the former to redesign its VAT system completely, or even fully abolish VAT. However, considering that VAT accounts for about 17% of all government receipts,² it is highly unlikely that VAT would be abolished or that the range of goods and services benefiting from reduced or nil rates or subject to an exemption would be substantially increased. Such changes would come at major costs for the United Kingdom. Even though a major overhaul of the VAT system would most likely not be triggered as a consequence of exiting the European Union, the United Kingdom might still wish to adjust the VAT rates applicable to certain goods and services,³ as it would no longer be bound by the minimum levels stipulated under the [VAT Directive](#).⁴ With time, the differences between the two systems could become more extensive, given that the United Kingdom would not be bound to implement any amendments to the VAT Directive or the outcomes of the decisions of the Court of Justice of the European Union (ECJ) in the field of VAT.

As regards trading with the other EU Member States, upon exit, the United Kingdom would have the status of a non-Member State. Currently, VAT on intra-Community 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 when the goods are cleared or deferred under a duty and VAT deferment system. As a consequence of exiting the European Union, import VAT will be charged on importations from other EU Member States into the United Kingdom. The same would be applicable to goods entering the European Union from the United Kingdom. Such VAT might often times be recoverable; however, many enterprises would likely experience cash flow costs due to the lag between the moment of importation and the recovery of the VAT. While major amendments to the UK VAT system will most likely not be implemented, at least in the short run, enterprises entering into trade arrangements with other EU Member States would still be likely to experience increased compliance costs.

² For details, see <http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2016/>.

³ The limited discretion of the United Kingdom in establishing the VAT rates applicable on individual goods and services has raised a number of concerns from various commentators in the past. For more information, see <http://researchbriefings.files.parliament.uk/documents/CBP-7630/CBP-7630.pdf>.

⁴ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

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- **Excise duties:** Excise duties are not fully harmonized at the EU level; therefore, exiting the European Union would not imply major changes to the UK rules applicable in this area. However, the United Kingdom would not be bound by the agreed minimum rates or by any further EU decisions in this area. Excise goods transferred from or to the United Kingdom would no longer be subject to intra-EU trading rules but would be treated as non-Member State exports or imports.

Primary EU law, ECJ 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 judgments, 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 United Kingdom does not negotiate a position similar to the EEA States), the United Kingdom 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, found incompatible with EU law (see, for example, the landmark ECJ judgments C-196/04 [Cadbury Schweppes](#),⁵ C-446/03 [Marks & Spencer](#),⁶ C-264/96 [ICI](#)⁷ and C-18/11 [Philips Electronics](#)⁸). Doubts might also arise in the future in relation to the value of UK court decisions based on EU law. At the same time, other Member States would not be forbidden to discriminate against UK businesses. Among the four fundamental freedoms, only the free movement of capital applies in relations with non-Member States.

On 11 November 1998, the European Commission adopted a communication⁹ on unacceptable 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, that 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 regard 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 United Kingdom would no longer be bound by the State aid rules and could adopt more favourable regimes to encourage inbound investments; however, at the

⁵ UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, ECJ Case Law IBFD.

⁶ UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. Halsey (Her Majesty's Inspector of Taxes)*, ECJ Case Law IBFD.

⁷ UK: ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries (ICI) v. Kenneth Hall Colmer*, ECJ Case Law IBFD.

⁸ UK: ECJ, 6 Sept. 2012, Case C-18/11, *The Commissioners for Her Majesty's Revenue & Customs v. Philips Electronics UK Ltd*, ECJ Case Law IBFD.

⁹ Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation (1998 Commission Notice), (98/C 384/03), OJ C 383/2 (10 Dec. 1998), EU Law IBFD.

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same time, residents of the United Kingdom investing abroad would not be protected by the EU rules against State aid regimes in other Member States.

Corporate tax directives

Although direct taxes are not harmonized, the EU Member States have to exercise their powers in conformity with EU law. The European Union has also introduced several tax directives to facilitate the free movement of goods, capital, services and persons. After Brexit, the United Kingdom would no longer be bound by the EU directives. The other side of the coin is that UK companies would not be able to benefit from them either. What will this mean in practice?

The following tax directives would cease to apply:

- ▶ **Parent-Subsidiary Directive:**¹⁰ 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 that the residence state either exempts dividends received or grants a credit for corporate taxes paid on profits in the subsidiary state). The United Kingdom does not impose a withholding tax on outbound dividends. The effect of the directive being no longer available might result in double taxation and hinder foreign investment in the United Kingdom. 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 United Kingdom are taxed in his residence state), he is likely to give up his participation in the UK entity.
- ▶ **Interest and Royalties Directive:**¹¹ Interest and royalties paid by a company in the United Kingdom 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.
- ▶ **Merger Directive:**¹² 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 of an SE or 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 might be taxed without any deferral, and the carry-over of provisions and reserves and the takeover of losses would no longer be available.

In respect of inbound situations (i.e. payments made to UK recipients), many EU Member States provide, under their domestic law, a reduced withholding tax rate on dividends and interest, provided that the recipient of the income resides in an EU Member State. The reduction is usually rather significant. For example, dividends from Italy received

¹⁰ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

¹¹ Council Directive 2003/49/EC of 3 June 2003 on the common system of taxation applicable to interest and royalty payments made between companies of different Member States, as amended.

¹² Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares and to the transfer of the registered office of an SE or SCE between Member States.

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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,¹³ providing for, inter alia, exchange of information, applies. This directive covers an extensive list of income types for which information is exchanged and, together with the [Recovery Directive](#),¹⁴ has created an efficient toolbox to recover tax claims between Member States. After Brexit, UK resident recipients would be excused from the obligations under these directives; similarly, the United Kingdom would no longer be able to receive such information or recover tax claims from other EU Member States.

Social security

With effect from 1 May 2010, [EU Regulation No. 883/2004](#)¹⁵ and Implementing Regulation No. 987/2009, as amended by EU Regulation No. 465/12, on the coordination of social security systems, replaced the former EU Social Security Regulations.¹⁶ The regulations provide for a common social security territory covering all EEA States with effect from 1 June 2012.

The general rule is that employees are subject to the legislation of the Member State in which they are employed. Following Brexit, cross-border employees might be faced with a situation in which they are subject to more social security systems. This would affect migrants from Member States working in the United Kingdom, as well as UK migrants working in other Member States. The situation might be remedied by bilateral social security agreements. In addition, the United Kingdom might negotiate the applicability of EU Regulations, as in the case of EFTA or non-Member States.¹⁷

Transfer pricing

The United Kingdom is a party to the [Arbitration Convention \(90/436\)](#),¹⁸ which provides that, if the commercial or financial relations between two associated enterprises differ from those which would apply between independent enterprises, 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

¹³ Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC.

¹⁴ Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures.

¹⁵ Regulation (EC) No. 883/2004 of the European Parliament and of the Council of 29 April 2004 on the coordination of social security systems (OJ 2004, L 166/1; corrigendum in OJ 2004, L 200/1).

¹⁶ No. 1408/71, No. 574/72 and No. 859/2003.

¹⁷ With effect from 1 April 2012, both regulations are applicable in relations between Switzerland and EU Member States. With effect from 1 January 2011, Regulation No. 1231/2010 extends the applicability of EU Regulations No. 883/2004 and No. 987/2009 to nationals of non-Member States legally resident in the European Union, with the exception of Denmark and the United Kingdom. However, in the case of the United Kingdom, the provisions of EU Regulation No. 859/2003, in conjunction with Regulation No. [1408/71](#), continue to apply to nationals of non-Member States.

¹⁸ Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

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to waiver of 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 enterprises would still be eliminated.

Conclusions

The expected tax consequences of Brexit include exiting the customs union, exiting the harmonized VAT system and no longer being bound by EU law (including primary and secondary law); however, the extent of the tax implications will depend on the post-Brexit relationship between the United Kingdom and the European Union. It is not clear at the moment what this will be, but the future options available are acquiring an EEA membership, acquiring a status similar to Switzerland or adopting the status of a non-Member State. Each of these scenarios would bring different consequences.

Nonetheless, the United Kingdom remains a member of the OECD, and, therefore, the OECD recommendations will continue to influence UK legislation. As, in general terms, the EU provisions are coordinated with the OECD guidelines (especially with regard to more recent BEPS recommendations), the United Kingdom will most likely continue to share the EU values of fair taxation and combating tax avoidance.

IBFD welcomes your feedback. Please forward your comments to [Laura Ambagtsheer-Pakarinen](mailto:L.Ambagtsheer-Pakarinen@ibfd.org), Oana Popa and [Ruxandra Vlasceanu](mailto:R.Vlasceanu@ibfd.org), at L.Pakarinen@ibfd.org, O.Popa@ibfd.org and R.Vlasceanu@ibfd.org, respectively. They are members of the EU law reporting team with IBFD's European Knowledge Group.