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Brexit – What You Need to Know

The UK's EU Referendum on membership is looming on the horizon – What are the tax questions which UK policy makers will need to address if the UK ceases to be a member of the European Union?

The EU Referendum Act 2015 obtained Royal Assent on 17 December 2015 and provides for the following question to be put forward for voting in a referendum in the UK: "Should the United Kingdom remain a member of the EU or leave the EU?"

During the EU Council Summit of 18-19 February 2016, the Heads of State or Governments of the Member States of the European Union (EU) adopted a decision concerning a New Statement for the UK within the EU and a statement containing a draft Council Decision on specific provisions relating to the effective management of the banking union and of further consequences of further integration of the euro area, as well as an additional Declaration of the European Council and four additional Declarations of the Commission. That decision, the statement and the declarations address the four "baskets" proposed by the UK Government for EU reform in its letter of 10 November 2015 to the EU Council. The four baskets deal with economic governance, competitiveness, sovereignty and immigration. The government has determined that the referendum shall take place on 23 June 2016.

Overview of Tax Issues

In considering the questions which tax policy makers will need to answer if the UK ceases to be an EU member state, it is convenient to divide the discussion between indirect and direct taxes. This is because direct tax issues are currently reserved to each EU member state, subject to complying with EU rules on treaty freedoms and the relevant directives, whereas indirect taxes are harmonised across the EU. As the EU "interface" with the UK tax system is greater for indirect rather than direct taxes, it is likely that a UK cessation of EU membership will give rise to a number of indirect tax questions which UK policy makers will need to address immediately. However, across both the direct and the indirect tax spheres, UK policy makers will need to consider a wide range of issues which include whether there is sufficient legislative machinery in place to finance the government's spending objectives, to the design of new taxes and to more philosophical questions such as the interplay between EU and common law legal concepts.

Indirect Taxes: Customs Duties

Customs duties are a construct of EU Regulations and not domestic UK law. If the UK were to cease to be an EU member it would simply not have a mechanism through which it could charge customs duties. UK policy makers would, therefore, need to devise machinery for charging customs duties as a matter of priority, in order to plug any spending shortfalls. In addition, UK policy makers would need to consider the consequences of the UK's exports into the EU not being subject to the benefits of the existing customs union. Therefore, UK policy makers may be obliged to enter into a customs duty union with the EU, such as the one which is currently in place between the EU and the EEA.

Indirect Taxes: VAT

Although VAT is derived from EU Directives, it has been embedded into UK law through UK primary legislation. Therefore, UK policy makers will not be required immediately to devise new legislation to enable the government to preserve VAT revenues if the UK ceases to be an EU member.

UK policy makers will need to consider the UK's trading relationship with the EU in relation to VAT. UK businesses can currently supply goods and services to non-UK but EU business customers on a VAT-free basis subject to satisfying certain evidential requirements. Clearly this is a benefit to UK businesses. In order for this treatment to continue, UK policy makers would need to put a VAT agreement in place with the EU, which could be structured in the same way as the agreement currently in place between the EU and EEA, to enable UK businesses to make supplies to non-UK but EU businesses on a VAT-free basis.

In addition, UK policy makers will have to address a number of philosophical and more long-term questions. For example, will judgements of the CJEU have "persuasive authority" on VAT matters? In addition, the civil law concept of "abuse of rights" has been transported into UK law to address perceived VAT avoidance. Will the UK continue to use this concept or will more traditional UK methods of combatting tax avoidance, such as targeted anti-avoidance rules and case law based anti-avoidance rules, now be applied to VAT? In the medium to long term, UK policy makers will have the ability to shape the development of VAT. Areas which could be under review could include zero rating, reduced rates and the types of supply which are to be treated as VAT exempt. In addition, if policy makers decided it is appropriate, the UK could even choose to embark on a fundamental review of VAT by introducing a US sales tax type system.

Corporation Tax: Fundamental Freedoms

The UK's corporation tax landscape has been "shaped" by the EU's rules on freedom of movement and discrimination. Examples of where these EU rules have driven changes in the UK include the introduction of an exemption from corporation tax for non-UK as well as UK dividends, the ability to claim group relief by tracing the group relationship through non-UK companies, the (limited) ability for UK companies to claim group relief surrenders from EU subsidiaries, UK to UK transfer pricing, and the restriction of UK offshore anti-avoidance provisions in relation to business operations in the EU to "wholly artificial arrangements intended to avoid the UK tax normally payable" (as per *Cadbury Schweppes*). Some of these changes have increased the UK's tax base, such as UK to UK transfer pricing. However, a number of developments have reduced UK tax revenues, e.g. the restriction on offshore anti-avoidance measures to "wholly artificial arrangements". If the UK ceases EU membership, UK policy makers will have to consider what to do with these historic changes to the corporation tax landscape. There would be no need for the UK to make any changes as they are already part of UK law. The decision to make any change would be solely at policy makers' discretion. It may be the case that any changes will be made on a piecemeal basis driven by the need to maximise tax revenues rather than there being a "route and branch" reform.

Direct Tax: Directives

If the UK ceases to be an EU member then a number of directives will cease to apply to it. Examples of the directives include the Parent/Subsidiary Directive, the Interest and Royalties Directive and the Mergers Directive.

These three directives have been selected as examples because they facilitate business between the UK and the EU. For example, the Parent/Subsidiary Directive and the Interest and Royalties Directive allow payment flows such as dividends, interest and royalties to be made without withholding taxes. The Mergers Directive is designed to facilitate cross-border mergers within the EU.

UK policy makers will need to consider the impact (if any) of these directives ceasing to take effect on UK business. The UK has agreed double tax treaties with each of the individual EU member states and it may be the case that these treaties provide a sufficient mitigation of withholding taxes on payment flows such as dividends, royalties and interest to compensate for the Parent/Subsidiary Directive being unavailable. However, the UK would need to carry out an analysis of the relevant treaties and, if necessary, seek to renegotiate accordingly. The absence of the Mergers Directive would create a different conundrum. This is because there is currently no mechanism outside the ambit of that directive to facilitate mergers within the EU. Policy makers would need to consider the impact of the Mergers Directive being unavailable on UK business and, if necessary, devise and negotiate an appropriate replacement treaty mechanism to facilitate cross-border mergers.

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