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BREXIT – Impact on Taxation

What might happen to UK tax now that the UK has voted to exit the European Union (Brexit) in the national referendum?

Direct Taxes

The UK tax system has been shaped over the last fifteen or so years to comply with EU fundamental freedoms including in particular freedom of movement of capital and establishment. This has been prompted by a string of tax decisions of the European Court of Justice.

From a business perspective, the result has been for our system to become more territorial, taxing UK profits and taxing non UK profits where those profits have been diverted from the UK in an essentially artificial way. Also, withholding taxes on cross border intra-group dividends, interest and royalties have been removed or reduced within the EU.

Expanding the tax base

Leaving the EU provides an opportunity for the Government to start expanding the UK tax base again by moving away from a purely territorial approach (for example re-imposing tax on dividend income from non-UK companies, removing the exemption available for branch profits etc) but it must be remembered that an effect of the above has been to make the UK tax regime more competitive internationally and the Government is unlikely to want to lose that advantage.

Leaving the EU will not free the UK from its extensive double tax treaties with the rest of the World. These treaties seek to prevent double taxation and award each contracting state the right to tax different slices of the economic activities covered by the treaties. These treaties will take on increased importance with the loss of the EU Parent/Subsidiary Directive and the Interest and Royalties Directive (which exempt from withholding tax certain cross-border payments).

The UK is committed to the G20/OECD Base Erosion and Profit Shifting (BEPS) project (which the EU Commission also supports in its Action Plan). Regardless of the decision to leave the EU, the UK will implement the BEPS recommendations tackling international tax avoidance.

Groups

The definitions of 'group' for various UK tax purposes (for example group relief of losses and capital gains tax) has evolved over the years to permit tracing ownership through non UK companies, mainly to avoid contravening EU fundamental freedoms and discriminating against non UK companies. Modifying the definitions to prevent such tracing could cause problems for many UK groups which have complex ownership structures involving non UK companies either at their head or at intermediate levels in their structure.

Exit taxes and cross border mergers and reorganisations

Another EU driven feature of the UK tax system is the removal or the easing of exit tax when a business moves from the UK to another EU member state (for example tax on deemed disposals of assets) and also the introduction of tax reliefs where cross border mergers and reorganisations occur. Leaving the EU will enable the Government to think again about whether to resurrect an effective tax barrier to such business mobility.

It was an EU Directive that caused the UK to abolish capital duty on the issue of shares by a UK company. Might this be reintroduced if the UK decides to leave the EU?

CCCTB

The EU Commission's plans include the introduction of a Common Consolidated Corporate Tax Base (CCCTB) for the taxation of companies within the EU (which involves aligning member states' tax regimes and agreeing on an allocation of shares of the tax pie between states in which companies operate). The UK has been opposed to these plans but exiting the EU will provide only a partial solution as UK groups continuing to operate within the EU will remain exposed to the CCCTB if ever it is adopted.

Tax Incentives

Because of the EU rules on State Aid, the UK tax system had to dismantle the generous treatment on investment in Enterprise Zones. It was on the back of 100% capital allowances that certain developments were founded. The few tax incentives left have generally required EU Commission approval which is given sparingly. Leaving the EU might allow the UK to restore more generous tax benefits for the Government's favourite projects such as the creation of the Northern Powerhouse and other infrastructure initiatives.

Whilst there is much uncertainty, leaving the EU will allow the Government opportunities both to raise more tax revenue by enlarging the tax base (which could harm the UK's competitive position internationally) and also to create more tax incentives. However, some flexibility may be lost depending on how the UK, post Brexit, chooses to negotiate trade agreements etc with members states.

VAT

Historically, the UK's membership of the EU meant that it was locked into applying the EU VAT system, which allows member states only a limited discretion to decide their own detailed VAT rules in specific areas. Brexit means that the UK will no longer be fettered in this way. The UK could dispense with VAT altogether (perhaps replacing it with a US-style sales tax) or maintain some type of VAT system.

The key difference between a sales tax and VAT is that the former applies, generally, only at the retail stage; by contrast, VAT applies at all stages of the production and distribution chain, with credit being allowed to the receipt of the supply at each stage.

If the UK were to maintain a VAT system, it would have to decide how far, if at all, this system would differ from the current VAT rules. The scope of each of the various exemptions and reliefs currently applied could be either extended or reduced. Political pressure and Treasury considerations are likely to play a significant role here.

Given the global trend towards countries applying a VAT system, our expectation is that the UK would continue to apply some form of turnover or sales tax, most likely along the same lines as the EU system as it generates considerable funds for the exchequer. The very fact of the UK being outside of the EU would lead to some changes in how the rules apply to specific transactions, particularly in circumstances where services are supplied between the UK and EU member states.

Custom Duties

Brexit would mean that the UK would no longer be part of the single economic market. Customs Duties would therefore apply, in principle, to transfers of goods between the UK and EU member states.

However, one would expect that in practice the UK would join the group of European countries which have special arrangements with the EU, meaning that there may not be any significant change with respect to many categories of transactions.

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