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BREXIT UPDATE AND TAX GUIDE

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In this document we look at the current progress of the Brexit negotiations and key tax changes that may result from the United Kingdom leaving the European Union.

Although the UK's scheduled departure from the EU is now little more than a year away, there is considerable uncertainty about almost every aspect of the future arrangements for trade, tariffs and tax. Despite this, it is now essential to begin planning for the future and businesses need to take professional advice on some of the steps they can take to future proof their operation.

What could Brexit look like?

As with any commentary on specific consequences of Brexit there is huge uncertainty about how, when and even whether any changes will take place but, assuming that there is no “exit from Brexit” then we see three broad scenarios:

Brexit in name only (BINO) - often used as a derogatory term by supporters of a “hard” Brexit, this refers to the UK remaining a member of the single market and customs union or putting in place equivalent arrangements which have the same effect as continued membership, but perhaps with some cosmetic differences. Supporters of this approach consider that it would minimise disruption to business; opponents complain that it would leave the UK as a “rule taker” bound by single market rules but unable to influence them.

Gradual divergence - this is an approach of definitively leaving the EU institutions in order to allow the UK to develop its own distinctive trade relations with the rest of the world, but without an immediate hard breakaway from the existing EU relationship. It remains unclear which elements of the EU relationship the Government sees as worth sacrificing to obtain greater advantages elsewhere - over time, the aim would be to negotiate case-by-case arrangements which combine all or most of the benefits of EU membership with freedoms from the restrictions that it is seen to impose.

Exit to WTO terms - sometimes referred to as “hard Brexit” or “no-deal Brexit” this would be the situation that resulted from the UK leaving the EU under the terms of Article 50 without any future relationship being agreed. The UK’s relationship with the EU would be that of a “third country” meaning that it would have no special access to EU markets, and would not be bound by any EU rules. There is uncertainty about the consequences for the UK’s relationship with countries outside the EU in this case as many such relationships are governed by treaties and agreements covering the whole of the EU, which were put in place when the UK was an EU member.

The picture is complicated further by the possibility of a “transition period” intended to give the UK and the EU time to prepare for future changes to their relationship. From the EU’s point of view this would mean the UK ceasing to be a formal member but maintaining its existing relationship with other EU members under EU rules for a set period of time. Although the UK Government has not expressed a single agreed view on what it wants a transition period to look like, it seems that it would like a more flexible approach allowing some scope for divergence and ability to develop new trading agreements with non-EU countries during the period. It is generally expected that a transition period, if agreed, will last for around two years, and will not exceed three years so that it is not ongoing by the time of the 2022 UK General Election.

What is the current state of negotiations?

The joint report, presented by EU and UK negotiators in December 2017, stated that both Parties had reached agreement in principle across three areas under consideration in the first phase of negotiations:

Protecting the rights of Union citizens in the UK and UK citizens in the Union - EU citizens in the UK, and UK citizens in the rest of the EU, will have the right to stay, along with their children and partners in existing 'durable relationships'. The UK courts will preside over enforcing rights over EU citizens in Britain but can refer unclear cases to the European court of justice for eight years after withdrawal.

The Irish border - the agreement promises to ensure there will be no hard border and states that the whole of the UK, including Northern Ireland, will be leaving the customs union. It gives no detail on how an open border will be achieved but says in the absence of a later agreement, the UK will ensure "full alignment" with the rules of the customs union and single market that uphold the Good Friday agreement. It also states that no new regulatory barriers will be allowed between Northern Ireland and the rest of the UK without the permission of Stormont in the interest of upholding the Good Friday agreement.

The financial settlement - the UK agrees to continue to pay into the EU budget as normal in 2019 and 2020, and also agrees to pay its liabilities such as pension contributions. There is no figure on how much the UK is expected to pay but the document sets out how the bill will be calculated – expected to be about £50bn.

In addition to these, the two sides agreed there would be need for cooperation on nuclear regulation and police and security issues. The report also includes an agreement to ensure continued availability of products on the market before withdrawal and to minimise disruption for businesses and consumers. It recognises the need for legal certainty, and for goods to continue to circulate on markets without need for modification or re-labelling.

The EU Withdrawal Bill, which would see EU law transposed on to the UK's statute books and repeal the European Communities Act, has a long Parliamentary process to complete before it becomes law. Several amendments are already tabled for debate and the House of Lords still await their turn to scrutinize the proposed legislation. Once this Bill has been passed, the process of copying across all existing EU legislation, and the approximately 20,000 rules and regulations affected by Brexit, into domestic UK law will commence in earnest, requiring many new Acts of Parliament and an estimated 800-1,000 new Statutory Instruments.

In terms of the stage two negotiations, the British government wants to reach an outline agreement with the EU by the end of March 2018 on the transitional arrangements that will apply for around two years after Brexit (from March 2019 – March 2021). The government's hope is to ensure that UK access to the EU single market would stay largely unchanged during this period while new arrangements are put in place. However, they have also stated that final details of this transitional deal will almost certainly not be agreed until the entire exit agreement is sealed, most likely towards the end of 2018. David Davis has also suggested to MPs that the full exit deal and transitional arrangements may not be known right up to the end of March 2019, potentially leaving parliament to then vote to approve the exit deal after Britain has already departed the bloc.

The EU negotiating team has remained more optimistic, stating that they hope to get a transitional deal agreed by October 2018, although this will then have to be scrutinised by the European Parliament, the European Court of Justice and potentially 38 other regional and national parliaments. Whilst the UK cannot extend the process, the EU is able to vote to extend the timing of Brexit if an agreement is far from being reached. However their current position is that the transition has to take place under all existing rules and regulations (including budget payments, the jurisdiction of the European Court of Justice and the free movement of people), and that it should come to an end on 31 December 2020.

Under the current timings, the UK will cease to be a member of the EU at 11pm (UK time) on Friday 29 March 2019.

What is the most likely outcome?

It is hard to imagine the UK voluntarily taking the plunge of a no-deal Brexit with the massive economic upheaval and uncertainty that would result. However, given the significant minority of Conservative MPs who favour harder varieties of Brexit, the risk that the Government cannot obtain parliamentary support for any agreement reached with the EU is real. This means that no-deal by default has to be considered as a possibility.

Against this, the stated aims of the Government following the completion of the first phase of the negotiations, particularly relating to the Irish border, are to pursue an orderly exit from the EU which avoids the need for a hard border. Until acceptable alternative arrangements can be agreed, this means that the UK will maintain "regulatory alignment" with the EU. Many commentators see this as an effective commitment to BINO until gradual divergence can be negotiated. Barring a chaotic breakdown in the negotiations and/or the Government becoming unable to pass its legislation, it seems most likely that we will see a period of no significant change followed by some elements of divergence as and when they can be negotiated.

Given the speed at which the EU institutions move, this could mean no change for quite a number of years. Unfortunately this would also mean uncertainty about the possibility of change for an equally long period.

Bearing all of this in mind, in the following sections we look at different areas of tax and consider what changes may result as the UK begins to diverge from EU rules. Where there are significant foreseeable consequences that would result from a no-deal Brexit we also comment on those.

Customs duties

The area of taxation where the effect of Brexit could be seen most immediately is in the application of customs duties and tariffs on imports from and exports to the remaining EU27 nations. Member states are not permitted to levy any duties on goods crossing a national border within the EU, whether those goods were originally produced inside or outside the EU.

If the UK follows the Prime Minister's stated intention to leave the Customs Union, imports from the EU will be treated in the same way as those from any other country. This would mean that UK importers would need to pay customs duties on a variety of goods as well as managing the administration of these imports. This poses a particular challenge for businesses with integrated supply chains entirely within the EU, who do not currently need to deal with significant import administration. For businesses with a mix of imports and exports, the challenge is more one of quantity. To give an idea of the scale of the increase in administration, HMRC processed 55 million customs declarations in 2015 and expects that figure to increase to 255 million following Brexit.

In order to simplify this process, one option is for affected businesses to obtain *Authorised Economic Operator (AEO) status*. This can be granted to businesses that demonstrate themselves to be trusted and compliant members of the international supply chain and as a result have access to simplified customs procedures, minimising the need for import examinations and reducing requirements for financial guarantees.

The AEO accreditation process can take several months. Typically pre-Brexit it was taking six months, but some commentators expect that to increase to a year as we approach Brexit itself and move beyond it. For businesses that could benefit from AEO status it is therefore important to get the process underway as soon as possible.

Another response that businesses may consider is relocating parts of their operations to EU countries. This could be particularly beneficial for businesses that have substantial imports from and sales to EU countries. Although there are significant costs associated with this kind of upheaval, these should be balanced against the ongoing business cost of dealing with two (or more) layers of import and export and administration for every sale.

There remains a realistic possibility that the UK will pursue a BINO approach in relation to the Customs Union – the December agreement promises full "regulatory alignment" in order to preserve an open Irish border – but current Government rhetoric still suggests this is a staging post rather than a final destination. Effectively all options are left open, and this means that businesses should review their business model and procedures to ensure that they are best prepared to deal with whatever outcome emerges from the next phase of negotiations.

VAT

If the UK leaves the EU VAT area, an immediate consequence could be the need for businesses to pay VAT on imports of goods from EU27 countries upfront in line with the system that currently applies to imports from the rest of the world. Most businesses would still be able to recover this VAT meaning no effective difference in net costs but given the scale of imports from the EU to the UK, its imposition would result in a significantly increased cash flow burden for British businesses as well as increased administration.

On 8 January the Treasury promised to "look at options to mitigate any cash flow options" from such a change, but added that the Government had not yet decided whether to remain in the EU VAT area.

Further consequences of the UK leaving the EU VAT area would include the distance selling rules ceasing to apply. Currently, UK businesses that make sales of goods from the UK to non-VAT registered customers in other EU countries have to register for VAT in other EU countries when 'distance selling' thresholds are exceeded. The good news is that if the UK leaves the EU VAT area such sales would be treated as exports and zero-rated for VAT purposes. Separate EU VAT registrations would not be required. In addition, there should be no need to submit EC sales lists and intrastats, representing a reduction in the administrative burden.

Another area where change will be required is for those businesses falling within the Tour Operators Margin Scheme (TOMS). It is understood that there may be a requirement for businesses making affected supplies to register in the EU, possibly in just one country.

There would also be knock-on effects on the VAT recovery rate of partially exempt businesses that export to the EU. Where partial exemption special methods have been designed in the light of a mix of EU and non-EU exports it may be necessary to renegotiate them in order to preserve recovery rates and take advantage of new opportunities.

Looking at potential changes to the domestic VAT regime, EU VAT law is fairly well harmonized although the UK is permitted some special arrangements such as zero-rating certain items. In theory leaving the VAT area would allow far greater flexibility to change the UK regime; in practice, it seems unlikely that the Government would implement major changes at the same time as the upheaval forced by Brexit. Once again, gradual divergence seems a likely outcome, with the Government perhaps taking advantage of its greater freedom to use the VAT regime to incentivise or discourage certain behaviours in a way that is not currently possible.

Given that VAT is a 'European tax' which is largely enshrined in EU law and heavily influenced by European court decisions, there is uncertainty about the status of past and future court rulings in relation to UK VAT law. This is a point of detail to be dealt with in the course of the negotiations and new UK legislation which could have a large impact on ongoing and future VAT disputes.

Corporation tax

The core of the UK corporation tax system is not harmonized with EU rules, meaning that the immediate effect of any type of Brexit should be limited. Many areas where a closer approach has been pursued between the UK and EU nations results from participation in OECD initiatives, and there is no indication that UK will seek to diverge from that approach in future.

However, some important changes will result from the UK ceasing to be party to rules such as the Parent-Subsidary directive, which makes it easier for parent companies to receive dividends from subsdiaries elsewhere in the EU without suffering withholding tax. UK companies may be forced to rely on double taxation agreements to minimize withholding tax in future, and in some cases it will not be possible to reduce such taxes to zero. A similar situation applies in relation to some interest and royalty payments between associated companies.

More generally, the potential loss of non-discrimination protections will mean that cross-border company and branch structures could become less flexible and more prone to tax disputes. International groups should model their future cash flows in the light of possible future scenarios and consider whether restructuring would be beneficial.

Some members of the Government see the ability to take a more “aggressive” approach to corporation tax competition as one of the advantages of Brexit and in a no-deal scenario it’s possible that the UK could adopt lower corporation tax rates and other measures to make the UK a more attractive location for internationally-mobile businesses. However, taking this approach could make it harder for the UK to establish a positive trading relationship with the EU27 in future and may not be compatible with existing OECD commitments so on balance it seems unlikely that we will see major changes in this area.

Employment issues

The EU social security co-ordination regulations are expected to cease to apply following Brexit. These provide certainty on where internationally-mobile EU citizens should pay their social security contributions and allow recognition of historical contributions made in one member state for the purposes of entitlements in another member state where the individual is resident.

The phase 1 agreement confirms that the rules will continue to apply to EU citizens resident in the UK or to UK citizens resident in EU27 states on the UK's withdrawal date and provides some comfort around the treatment of previous contributions. There is less certainty about the treatment of mobile citizens in future and it seems likely that administrative burdens on employers will increase as a result of greater complexity. The costs of employing workers from EU27 countries may also be higher due to the potential need to make higher social security contributions in order to protect some workers from being worse off under changed rules, and the potential for having to make double contributions due to mismatched rules between countries.

More generally, the administrative burdens around employing EU27 workers are likely to increase. The phase I agreement contains a commitment to streamline administration relating to residency status across the withdrawal date which should help to minimise the disruption to existing employment relationships. However, the UK's intention to take greater control of its immigration arrangements will inevitably result in short-term uncertainty and ongoing complexity for businesses seeking to employ EU27 workers.

What should businesses be doing?

Once the future relationship between the UK and the EU27 is known, Brexit may offer businesses a range of opportunities, but is also likely to pose threats. At the present time there are still many unknowns, and plans to mitigate potential threats will involve preparing and taking action before knowing what is actually agreed in any transitional agreement.

We have prepared a document to help businesses review the potential impact of Brexit across areas of their operations: https://www.pkf-francisclark.co.uk/news-views/blog/aeo-mark-quality/
With little more than a year to go before the UK's scheduled departure from the EU it is vital to take action now. Please contact one of our Brexit team below, or your usual specialist.

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