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# Tax Implications of Brexit –The Road Ahead

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## **Abstract**

*On 23<sup>rd</sup> June 2016, the people of United Kingdom voted to exit from the European Union. This exit impacts the economies of the UK and EU both in many ways. Numerous changes in taxation structure, tariffs, business methodology will be seen. These tax implications and the impact of the exit decision on economy and business are unclear. This article analyses the legal implications and the process of exit to be followed after the referendum and the various strategies to proceed and their legal standing are discussed. The main issues that the economies of UK and EU shall face are discussed in the article. It also discusses the potential economic changes that might occur along with the impact of Brexit on corporate tax structure, social security, trade and other areas respectively.*

## **Introduction**

23<sup>rd</sup> June 2016, the day of referendum in UK towards Brexit [British exit from the EU] goes a long way in the history of Europe. Majority of the British people democratically mandated in favour of the United Kingdom (UK) leaving the European Union (EU). An interesting feature of the referendum was that the citizens of Commonwealth countries, currently living in UK with long-term UK visas, were eligible to vote, along with the UK citizens. There are 53 member countries in the Commonwealth almost twice the number of the countries in the EU. There is disparity in the general state of development in member countries and they are affected differently due to Brexit. There is a crucial distinction between Commonwealth voters staying in the UK on temporary visas and British citizens with racial origin in the Commonwealth countries, who now possess UK passports. Brexit will have different impacts on people, who wish to settle down permanently in the UK and others, who do not have any such aspiration. UK staying as a part of EU or leaving it will not affect all voters alike. Against this backdrop, there can be significant effect of Brexit on Indian economy. Many Indian companies, such as Tata Motors, have shifted primary manufacturing to the United Kingdom and are treating India as a market for the finished products. The capital of many of these companies is being invested in the UK, which

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generates jobs in the UK. Uncertainty of the outcome of Brexit may have an impact in the long run. On the other hand, UK companies constitute India's largest G-20 investors, employing large number of people across India. Post-Brexit, India and the UK might have a free-trade deal. Again, there is uncertainty and no surety even if it would be desirable at India's current level of development. Indian immigrants in the UK belong to all classes. Working class Indians in the UK are adversely affected by the preferential treatment of continental European labour. UK outside the EU is beneficial for labour in India. A cheaper pound as an outcome of Brexit has made Indian imports cheaper, thereby helping the Indian trade. A cheaper pound vis-à-vis the Indian rupee would mean larger pound reserves, benefitting the economy. In addition, thousands of Indian students in the UK, who transfer Indian rupees to their UK bank accounts for tuition fees and personal maintenance, would benefit from the pound's devaluation.<sup>1</sup> While the pound's depreciation reduces the cost of imports, it is unlikely to be of an overall advantage if it disproportionately hurts Indian exporters.

This has led to the country navigating uncharted territory and the implications are ambiguous. There are number of tax propositions and the impacts of the decision on the economy and business are unclear. There are different interpretations regarding the applicability of the referendum, some feel that the referendum has only an advisory status and the government is not bound to follow the decision. The powers of the Prime Minister are also being interpreted. One group of people feels that the prime minister has power, under Article 50 (2) of the Lisbon Treaty, to trigger Article 50 without reference to parliament.<sup>2</sup> Others argue that only parliament can authorise triggering of Article 50 of Lisbon Treaty. Article 50 of the Lisbon treaty provides that any country that intends to withdraw has to notify the European Union of its intention. After the notice of intention is given, all the negotiations have to be completed in 2 years. Any extension beyond two years has to be ratified by all member states. It is also argued that the powers of the prime minister cannot be used to undermine parliamentary statute. Article 50 also says that any EU member state can leave "in accordance with its own constitutional requirements". The above phrase has given lawyers food for thought. UK Constitutional Law Association argues that under constitutional settlement the prime minister cannot issue a notification under Article 50, without being given authority to do so by an act of Parliament. Without Parliament's backing, the prime minister would be exercising prerogative powers. Prerogative powers are a collection of executive powers held by the Crown since medieval times and now placed in the hands of ministers. Case laws have established that

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<sup>1</sup> Abhijit Sarkar, 'Spoils of Brexit for India', vol.51, *Economic and Political Weekly*, 2016, pp.36-38.

<sup>2</sup> Owen Bowcott, 'First Legal Attempt to Prevent Brexit Set for Preliminary Hearing', *The Guardian* (July 2016) available at <https://www.theguardian.com/politics/2016/jul/08/legal-attempt-prevent-brexit-preliminary-hearing-article-50>, accessed on 2May 2017.

legislation can only be altered by legislation. Invoking Article 50 would lead to overriding of the 1972 European Communities Act, which provides Britain membership of the EU and allows EU treaties to have effect in its domestic laws.<sup>3</sup> It is argued that only parliament has the power to repeal the European Communities Act 1972. Experts also feel that taking the pulse of the parliament would provide an opportunity for the MPs to express their views on Brexit, and majority is already in favour. It is expected that Parliament would pass an act and give powers to the prime minister to start the exit process. There is also a proposition that Scotland may take steps to block the exit. The Sewel Convention is a Memorandum of Understanding between the UK and Scottish Government and it provides that the Westminster Parliament will not legislate on devolved matters. Thus, powers of Scottish Parliament are limited by EU law. It is argued that if Brexit legislation enacted by the UK removes these limits then the Scottish Parliament would be free to make laws that breached EU law. There would thus, be a need to get the Scottish Parliament's consent under the Sewel Convention. The UK Parliament is sovereign. It authorises devolved legislatures to make law in certain areas. It also retains the right to make any law. The two-year cooling period could go on without any agreement or legislation by the British Parliament. Thus, Scottish Parliament would have no legislation to withhold its consent and even if consent is withheld the British Parliament can override it. There is also a call for a second referendum, as both the sides achieved less than 60%; on a turnout of less than 75%. Second Referendum is constitutionally possible but not politically.

Britain's withdrawal from the European Union was scheduled for a preliminary hearing in the high court on 19<sup>th</sup> July, 2016 which was postponed to October. It was a politically sensitive hearing where the High court ruled that the Theresa May Government cannot trigger Article 50 of the Lisbon treaty without a vote in parliament authorising to do so. This verdict has cheered the economy and the Pound under pressure since Brexit jumped after the ruling though the ruling will have multiple implications. The government will be appealing against the verdict of the Supreme Court. Majority of MP's and Lords are in favour of Britain remaining in the EU but it is not still clear whether the parliament would need to pass a legislation authorising the government or vote on a motion on the issue. The entrepreneurs, who brought these cases, had argued that such fundamental change could not be triggered by ministers alone and it would undermine the sovereignty of the parliament. It is also felt that this would delay the withdrawal process. This verdict will also give time to resolve the domestic questions like status of Scotland or border issue with Ireland before the two years' clock of withdrawal starts ticking.

### **Tax Implications**

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<sup>3</sup> Rev Peter Simpson, *Biblical case for Brexit: Why Britain Should Leave the European Union and Return to its Historic Christian Foundations*, Belmont House Publishing Ltd, Sutton, 2016.

The analysis on the implications of a 'leave' vote according to Angel Gurría, secretary general at the OECD, would be a 'taxing one'.<sup>4</sup> It is felt that the consequences of Brexit are complex and permanent, and not only for the UK but also for the rest of the EU members as well. Brexit would be like a tax on the British economy. It would be a cost incurring, which provides no benefits to the economy. The two years' Brexit notice period will allow companies time to reflect and review their international strategies and structures. Depending upon terms of exit and the consequential changes made to the UK domestic tax system, the businesses will also see a great deal of changes. The impact of Brexit on UK tax law can only be determined after knowing the terms of the exit negotiated between the UK and the EU. The future economic decisions and changes in domestic law will also have an impact. There are many ways the relationship between the UK and EU may take shape and it will take a long time for relations to stabilize. Some options/situations are as follows:<sup>5</sup>

- Britain may leave EU but be a part of European Free Trade Association (EFTA) and the European Economic Area (EEA) will allow UK access to the common market like Norway & Iceland. It will also lead to UK contributing in EU spending.
- There are questions of the independence of Scotland
- Britain can negotiate a free trade agreement with the EU like Switzerland, in trade sectors
- Britain can negotiate a custom union with the European Union like Turkey

### OECD Policy Paper

The Organisation for Economic Cooperation and Development (OECD) has published a policy paper on 'the economic consequences of Brexit: A taxing decision'.<sup>6</sup> The report outlines the economic shortfalls and long term outlooks of Brexit. It mentions about the increase in GDP of the United Kingdom which has doubled, outpacing other countries.

Opinion polls have also suggested that Brexit would hurt the confidence of business and weaken the growth. The impact of Brexit will be visible in time. The formal exit would

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<sup>4</sup> Amelia Schwanke, 'Taxing Concerns over Brexit VAT Perspective' *International Tax Review Website*, available at <http://www.internationaltaxreview.com/Article/3557642/Taxing-concerns-over-Brexit-VAT-perspective.html> accessed on 20 June 2016.

<sup>5</sup> Roger Liddle, *The Risk of Brexit: Britain and Europe in 2015*, London Rowman & Littlefield International Ltd, London, 2015.

<sup>6</sup> Rafal Kierzenkowski, et al, 'The Economic Consequences of Brexit: A Taxing Decision', *OECD Economic Policy Papers*, 2016, available at [http://www.oecd-ilibrary.org/economics/the-economic-consequences-of-brexit\\_5jm0lsvdkf6k-en](http://www.oecd-ilibrary.org/economics/the-economic-consequences-of-brexit_5jm0lsvdkf6k-en) accessed on 2 May 2017.

occur in late-2018 followed by new trade measures and policy to reduce immigration over 2019-23. The following channels would operate short term:

- Economic uncertainty
- Increased cost of finance
- Increased capital outflows leading 7% of GDP deficit.
- Trade would possibly be governed by World Trade Organisation rules. It would lead to higher tariffs for goods and services. There are also chances that trade between UK and EU would diminish
- There might be a Free Trade Agreement with the EU
- Negotiating new trade treaties
- Reduced incentive for Immigration
- Appreciation of other currencies against sterling

Brexit would also lead to substantial structural changes in the economy and new policies over 2024-30, most important of them would be as follows:

- Less business investment in UK and a decline in the capital
- Technical progress and productivity are also expected to decrease.
- GDP growth is expected to reduce due to lower immigration and reduced Foreign Direct Investment
- Transfer to EU budget will come to an end but fiscal savings are likely to be 0.3-0.4% of GDP only.
- UK will have lower share in global trade<sup>7</sup>

It is predicted that, by 2020, the GDP of Britain would be more than 3% which is less than if it were continued with EU membership, and by 2030, GDP would be more than 5% lower than projections estimate it. Treasury, the Governmental finance in-charge of UK feels that productivity and GDP would decrease post Brexit and this would outweigh potential benefits. Brexit is not a tax event but there will be many quantifiable effects on the tax law. Fundamental changes will necessarily arise from the complete overhaul. Side effects of changes in tax will be seen with passage of time.<sup>8</sup> British government will need to focus urgently on tax and other pressing business issues along the noise of politicians, campaigners and media corporations. Potential implications of Brexit on economy and tax structure are analysed as follows.

### Withholding Taxes

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<sup>7</sup> Ibid.

<sup>8</sup> Tim Sarson, 'Brexit: What Would it Really Mean for Tax' ,*International Tax Review Website*, available at <http://www.internationaltaxreview.com/Article/3541647/Brexit-What-would-it-really-mean-for-tax.html> accessed on 2 May 2016.

The European Union directives promote free trade in businesses operating across the EU. Its regulations operate automatically without the need for members to implement it. They will continue to bind the UK until the date of withdrawal. Moreover, the UK has many domestic laws that have been based upon or heavily influenced by EU law, for example, The Equality Act 2010. These laws will continue to bind the UK until they are formally repealed by Parliament. There are also a number of EU Directives, which facilitate business.<sup>9</sup>

The Parent-Subsidiary directive removes withholding tax on dividends paid between associated companies within the EU. Similarly the interest and royalties directive eliminates withholding tax on interest and royalty payments between associated enterprises within the EU. If these directives do not apply, double taxation of dividends could arise. There could be withholding of tax costs on payments of interest and royalties.<sup>10</sup> These key directives prohibit withholding taxes on intra-group interest, dividend and royalty payments within the EU. After Britain withdraws from the EU, the protection of these EU directives will not be available and companies will have to rely on double taxation treaties. Some double tax treaties may also require re-negotiation of certain provisions. UK may also re-visit withholding tax rules and may abolish the withholding tax on interest like many other jurisdictions. The “merger directive” facilitates cross-border reorganizations between companies in different EU member states. Britain may not follow the merger directive that allows removal of fiscal obstacles across EU. This directive also allows for the deferral of certain taxes. The leave vote could result in tax being imposed on cross-border mergers between UK and EU businesses. There will be huge impact as other directives like parent subsidiary directive, interest and royalty directive will no longer be available to UK-based businesses. The capital duties directive prevents EU members from imposing tax on share issues. Following this directive, UK had to restrict its 1.5% stamp duty reserve tax charge on share issues into depository. This charge could be imposed more widely again after Brexit.<sup>11</sup>

### Corporate Tax Systems

The direct tax system in UK is consistent with the EU law such as the principle of fiscal neutrality and the fundamental freedoms of movement of capital, people and services. Britain has amended its tax law many times to comply with the EU law. Decisions of the Court of Justice of the European Union have affected the tax system of UK for example, its controlled foreign company rules. If the UK follows EEA then the benefit of the EU fundamental freedoms can be taken. If UK does not become part of the EEA, then

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<sup>9</sup> Mark Burgees, et al., ‘Brexit: What are the implications for tax law?’ 24 June 2016, *Insights DLA Piper Website* available at <https://www.dlapiper.com/en/uk/insights/publications/2016/03/brexit-implications-for-tax-law/> accessed on 3 July 2016.

<sup>10</sup> Mason Hayes and Curran, ‘EU Anti Avoidance Directive and Irish Holding Companies-Taxation of Dividend’, 1 July 2016, *International Tax Review Website* available at <http://www.internationaltaxreview.com/Article/3567026/EU-Anti-Avoidance-Directive-and-Irish-Holding-CompaniesTaxation-of-Dividends.html> accessed on 2 May 2017.

<sup>11</sup> Ralph Buckle, et al., *Brexit: Directions for Britain Outside the EU*, Institute of Economic Affairs, London, 2015.

amendment would be required in tax laws to distinguish between UK and non-UK taxpayers. The extent of these amendments cannot be predicted right now. If the British government restores the previous tax system and favours domestic companies then it will affect multi-national businesses and foreign company's jurisdiction in the UK. The EU has been working towards introduction of a Common Consolidated Corporate Tax Base (CCCTB). It is working towards uniform response to the recommendations made by the OECD in its Base Erosion and Profit Shifting (BEPS) reports last year. Britain has been a supporter of the BEPS recommendations but opposes CCCTB. Brexit could result in quick and fast introduction of BEPS recommendations.<sup>12</sup>

## VAT

VAT constituted 22% of annual tax revenue in 2014-15. In 1977, the EU harmonised VAT measures by the EU VAT directive which facilitated trade between EU members. In the first few years at least, post-Brexit, the UK would maintain a parallel VAT system with some technical changes. The current system of VAT would most likely continue to apply in the UK post-Brexit but the UK will have total flexibility to create desired modifications to its VAT system.

The UK VAT rules would change over time or there might be an extension of the zero rates. After this, there could be a change in main rate. New rules would have to be developed to distinguish between supplies made to or from the EU member states. The UK would lose access to the EU 'one-stop shop' mechanisms. There would be risk of double taxation or double non-taxation arising from a change between EU VAT laws to the new UK VAT law. Business would no longer have a comfort zone of VAT-related procedure. It will depend upon negotiations with the European Commission and exact changes are difficult to predict. There could be introduction of an import VAT on goods entering the EU from the UK that might result in cash flow issues for businesses. There will be administrative and structural changes to manage VAT registrations. Looking at all the issues the UK may maintain a VAT system which is substantially aligned with system of European Union or it may not.

## Customs Duty

The EU is a single market and there are no customs duties within the EU. The member states share common external tariffs with third countries. With the leave vote, the UK might leave the customs union as well. There is precedence for a third country (Turkey) to be a part of the EU's customs union. This seems particularly unlikely. EXIM transactions between the UK and the EU may be subjected to custom duties. It would be a disadvantage for the UK competitors compared with competitors from within the EU. The UK and the EU could also enter into a free trade agreement with no or very low customs duties. Most likely, UK will negotiate free trade agreements with the likes of the Commonwealth or NAFTA. UK's relationship with the EU, post-Brexit, will define the legal landscape in relation to customs. If the UK exits the EU's Customs Union, imports

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<sup>12</sup> Jonathan Lindsell, *Softening the Blow: Who Gains From the EU and How They Can Survive Brexit*, Institute for the Study of Civil Society, London, 2014.



and exports of it become subjected to customs duties.<sup>13</sup> There would also be issues like obtaining customs clearance on both imports and exports, which would also define the relations of EU companies and consumers with UK suppliers when purchasing goods. The costs will increase and it will affect the competitive supply along with manufacturing operations, in case the companies want to avoid customs duties.<sup>14</sup> The imports from the UK into the EU would fall into category of the EU's WTO "most-favoured nations" duties. These are significantly lower. This would put UK business in a disadvantaged position with competitors within the EU.

### Transfer Pricing

In regard to transfer pricing, there would be changes for multinationals with UK operations. Multinationals will be particularly sensitive to any increase in discrimination against the provision of services from the UK to the EU. Brexit will add to the significant changes emerging due to the BEP's project.<sup>15</sup> Changes in the tax structure may not be compatible with the EU plans.

### Social Security

The UK is part of the EU social security contributions system. UK workers, who work in other states, are only liable to pay social security contributions in one state. This arrangement will change after Brexit and workers may be liable for double social security contributions.

### State Aid

The EU competition law prohibits member states from giving subsidies and other aids to particular businesses or sectors. There has been scrutiny of tax rulings given to multinational enterprises. EU Commission has decided in many cases that tax rulings underestimated tax from companies and ordered recovery of the 'underpaid' tax. Following, Brexit, the UK may freely grant state aid.

### Trade between the EU and the UK

It would be beneficial if the UK and the EU would enter into a free trade agreement with very low or no customs duties. One-half of UK exports are to the EU while only around 10% of exports from the EU are to the UK. The EU countries also benefit from significant trade in goods surpluses with the UK.

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<sup>13</sup> Burgees (n 9)

<sup>14</sup> Trevor James & Sonia Girgis, 'Brexit: Tax Implications', 28 June 2016, *Morrison Forester Website* available at <https://media2.mofo.com/documents/160628brexittaximplications.pdf> accessed on 3 July 2016.

<sup>15</sup> Amelia Schwanke, 'Brexit: Britain The EU and the Most Worrying Tax Implications' *International Tax Review Website*, available at <http://www.internationaltaxreview.com/Article/3562882/Brexit-Britain-the-EU-and-the-most-worrying-tax-implications.html> accessed on 7 July 2016.

## Foreign Direct Investment

The UK is a hub of foreign direct investment of Europe. Headquarters of most of the multinational companies are based in the UK. Netherlands, Luxembourg, France, Ireland, Germany, Sweden, Spain, Belgium and Italy are main recipients of investment from UK. Subsidiaries in the EU may not be able to pay dividends or interest to their UK holding companies. There might be some solutions under bilateral double tax treaties but tax impacts will persist. France, Germany, Luxembourg, the Netherlands and Spain constitute 85% of FDI in the UK.<sup>16</sup> The UK may reintroduce UK tax rules contrary to the EU law. This would require positive legislative changes and policy decisions. EU member states may try arrangements of anti-avoidance rules with UK. Britain may adopt competitive tax regimes, which might be contrary to state aid rules. The EU is at crossroads now in terms of where, it will go with corporate income taxes. The Commission is pushing hard for full harmonisation by introducing the CCCTB.<sup>17</sup>

## Settlement of Disputes

Moving away from the arbitration convention may result in delay of the settlement of disputes. BEPS Action 14 will become applicable early and could solve the problem.

## Court of Justice of the EU

Following Brexit, the UK would no longer be bound by the European Commission and the Court of Justice of the EU. Many CJEU decisions favoured taxpayers. The UK has the thickest and most complex tax code in Europe and it is possible that EU case law will continue to have an effect. It might also be the case that ECJ case law will cease to apply. In such a situation, the cases pending in the court of law cannot have a cut-off date. All this will unravel slowly with the passage of time.<sup>18</sup>

## Conclusion

George Osborne, member of British parliament and Chancellor of exchequer has hinted that UK may cut the corporation tax rate to attract businesses post Brexit<sup>19</sup>. This could result in UK becoming a tax haven and may lead to a race amongst EU members.

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<sup>16</sup> Patrick Birkinshaw & Andrea Biondi, *Britain Alone! : The Implications and Consequences of United Kingdom Exit From the EU*, Kluwer Law International, Leiden, 2016.

<sup>17</sup> Allen & Overy, Brexit-Legal Consequences for Commercial Parties; Tax and the Implications of Brexit, February 2016, *Allen & Overy Website* available at [http://www.allenoverly.com/SiteCollectionDocuments/AO\\_05\\_Brexit\\_Specialist\\_paper\\_Tax.pdf](http://www.allenoverly.com/SiteCollectionDocuments/AO_05_Brexit_Specialist_paper_Tax.pdf) accessed on 2 May 2017.

<sup>18</sup> Anjana Haines, Brexit: UK Could Legislate against Application of ECJ Case Law, 24 June 2016, *International Tax Review Website* available at <http://www.internationaltaxreview.com/Article/3565132/Brexit-UK-could-legislate-against-application-of-ECJ-case-law.html> accessed on 2 May 2017.

<sup>19</sup> Anjana Haines, 'UK plans to cut 20% corporate tax rate', 4 July 2016, *International Tax Review* available at <http://www.internationaltaxreview.com/Article/3567357/UKplanstocut20corporatetaxrate.html> accessed on 2 May 2017.

It would maintain the competitiveness of the UK in attracting investment but would lead to competition and aggressive tax offers from UK. Besides the tax cut, Osborne also has other important plans to reassure the corporate houses which are:

1. Seeking investment from China
2. Worldwide support for bank lending,
3. Investing in the Northern powerhouse, and
4. Maintaining the UK's fiscal credibility.

Two important issues that the business houses will face can be predicted. First, there will be major trade impacts on physical supply chains while determining what kind of model fits in the post Brexit scenario. If the company relies on customs free access of EU then exports to the EU would be subjected to the EU's common external tariff. Companies would lose EU's bilateral trade deals with the rest of the world. The situation may be comparable to that of any of the countries. Norway is a member of the EEA; Switzerland is a member of EFTA but not the EEA; Turkey is a member of the EU Customs Union; And South Korea has a comprehensive FTA with the EU. It is also possible that UK accesses the EU under WTO rules.

So, if the UK went for a Norway type deal then exports to the EU would remain largely tariff free but exporters would be governed by 'rules of origin', thus global supply chains would be complex and costly. If UK were to follow Turkey then only goods shall be governed and services would be affected. The second big issue is whether a leave vote triggers a major business restructuring or not. Regulations of immigration rules will impact business. Business houses should identify two or three priorities for them in any Brexit deal. They should assess the importance of the EU membership and frame contingency plans. There can be no comprehensive answers yet.

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