EU and global tax implications of UK public vote to leave the EU

18 July 2016

In brief

In a 23 June 2016 referendum, the UK public voted to leave the European Union (EU). The implications for the UK, the EU and the rest of the world depend to a substantial extent on the agreed exit terms, as well as the negotiations with other countries. Given the comments from incoming Prime Minister Theresa May, it seems inevitable that the government will, at some point, notify the European Council of its intent to leave the EU. That notification triggers a two-year deadline for concluding negotiations. That deadline could be extended further by mutual consent of all Member States.

It has been widely speculated that the UK would wish to enter into some form of free trade agreement with the EU and the remaining EU Member States. Much would depend on the scope and terms of that agreement. Broadly, there are two main possibilities. In the first, the UK would negotiate either a customs union or bilateral free trade agreements with the EU, as have Turkey and Switzerland, respectively. In the second, the UK would remain a member of the European Economic Area (EEA), but as a non-EU Member. Currently, the EEA includes all the EU countries as well as Iceland, Liechtenstein and Norway. This process would also affect the need for the UK to negotiate trade deals separately with non-EU/ EEA countries.

There are many misconceptions about how the referendum vote impacts taxes, but it causes no major legislative tax changes directly. However, the market volatility that we've seen since the vote could affect some tax-related affairs. In addition, tax policy changes may, in time, result from what transpires. This bulletin briefly covers some areas of uncertainty and signposts to further materials without analysing the myriad scenarios which could play out.

In detail

The exit process

Article 50 of the Treaty on European Union (TEU – see also official version of treaty on Eur-Lex) provides for an EU Member State to leave the EU.

A Member State that decides to withdraw from the EU under this process notifies the European Council of its intention. This formal group of heads of state and government (minus the UK) would, under its permanent President Donald Tusk, then be expected to draw up guidelines for the withdrawal negotiations – a negotiating mandate.

The European Commission (EC) likely would lead the negotiations for the withdrawal agreement before seeking European Parliament (EP) consent and the ultimate decision-of the other 27 Member States in the Council of the EU with qualified majority voting in accordance with Article 238(3) of the Treaty on the Functioning of the EU (TFEU) excluding the UK. Concretely, this requires 20 Member States in favour, representing at least 65% of the EU-27's total population. Exit would effectively occur on the date the agreement comes into

effect or, if no such agreement is cast or the UK doesn't like the agreement, two years after the date of notification (assuming the European Council does not agree to an extension).

Upon exit, EU law would cease to apply to the UK. However, UK House of Commons briefing paper 7551 suggests that, "there might be acquired rights for EU and UK citizens". It states that the UK government and Parliament would decide which EU laws, rules and regulations to keep, amend or forego by repealing the European Communities Act 1972, with savings provisions. It would also be necessary to repeal secondary legislation insofar as it implemented EU law or directly applicable EU Regulations but, as a further UK House of Commons briefing paper 7632 points out, there is no reason why EU-based UK law could not remain part of UK law. In this case, the government would have to ensure that the law still worked without the UK being in the EU.

A number of questions will still need to be considered.

- What will happen with respect to case law and interpretation? How will courts construe parliamentary intention when interpreting statutory provisions that were put in place at a time when EU law was in place? This could give rise to significant uncertainty for businesses and the courts when trying to establish the correct treatment of a transaction(s).
- What will happen to EU law rights that were accrued while the UK was a member of the EU? Whether these will be protected upon the exit is likely to depend on the steps taken by Parliament to effect the exit, and the way in which the judiciary interpret statutory provisions, identify and protect domestic rights.
- What will happen to currently unresolved claims that are based on EU law? Until the date and legal form of the exit are known, it is difficult to anticipate the likely impact on such claims. However, businesses likely will wish to maintain them.

Choices for alignment

The decisions as to which EU-related laws the UK Parliament chooses to keep may be influenced by the nature of the withdrawal agreement (as discussed in our 24 June webcast) and in particular, whether one of the following main routes to continued realignment with the EU is adopted.

- EEA membership outside the EU – the fundamental EU Treaty freedoms of goods, establishment, people and capital would still broadly continue to apply across the EU and Iceland, Liechtenstein, Norway (but the UK would be free to impose customs duties regarding transactions with non-EEA members); EEA State aid rules are similar to those in the EU but some EU Directives would not apply.
- Bilateral/ multilateral agreements with the EU – these could include for example a customs union in relation to all or specified types of goods (cf. EU agreement with Turkey which prohibits customs duties and restrictions on export and import of industrial goods and processed agricultural goods) or free-trade arrangements that also allowed for, say, free movement of persons (cf. EU agreement with Switzerland), potentially including social security regulation/ protection.

The UK might join the European Free Trade Association (EFTA) which provides for free movement between its Members, but they are currently restricted to Iceland, Liechtenstein, Norway and Switzerland. Instead of EU-style State aid rules, the EFTA agreement refers to the General Agreement on Tariffs and Trade (GATT) 1994 and the World Trade Organisation (WTO) Agreement on Subsidies and Countervailing Measures.

The decisions which the UK takes in relation to trading etc with the Members of the EU/ EEA may have both direct and indirect effects with other countries. The free movement of capital within the EU Treaty applies also in relation to non-member (third) countries, for example. Ownership requirements for eligibility for some double tax treaty benefits may also be affected (e.g., some US treaties provide derivative benefits by reference to ownership within the EU/ EEA).

If the UK does not reach agreement with the EU, it may also be left with what we might call the WTO model. That would involve re-negotiation by the UK of various free-trade agreements (FTAs) that the EU currently has with third countries, as well as negotiations between the UK and EU Member States. This is one end of the scale between a 'hard landing' as regards the level of disruption in the forward-looking options and a 'soft landing'.

The EU currently has bilateral/ multilateral FTAs with the following countries: Albania, Algeria, Andorra, Bosnia, Colombia, Egypt, Faroe Islands, Georgia, Iceland, Israel, Jordan, Lebanon, Macedonia, Liechtenstein, Mexico, Moldova, Montenegro, Morocco, Norway, Palestinian Authority, Peru, Serbia, South Africa, South Korea, Switzerland, Tunisia, Turkey, Ukraine. Canada is also nearing completion.

Tax strategies, systems and finance transformation

The Brexit vote will result in a number of considerations for most organisations and their broad tax strategies, in particular how they deal with tax in the systems and in any wider finance transformation programs. While there is an urgent need to consider a number of accounting and reporting issues (see our Inform In-brief report 2016-29), the detail needed to accommodate new rules and regulations and emphasis from the tax authorities won't exist for some time.

This means that on changing the systems or finance policies and procedures, organisations will need to keep a watching brief until they have more certainty over their company's scenarios. However, whilst the detail isn't going to be available for most changes, certain sectors know more about the upheaval for which they need to plan (for example, financial services as discussed in our webcast of 1 July, but also a broad range of industries from tour operators to digital service suppliers). Most may have more macro issues to consider in the immediate future:

- businesses reviewing their organisational plans on the back of Brexit – whether in direction, operations and/or activities – to ensure that tax is part of the journey, and not dealt with retroactively
- design decisions being made for systems with cross-EU components (such as handling indirect tax obligations from one entity) to allow flexibility for inbound and outbound UK sensitive activities
- the roll-out of global tax-inclusive programs in phases - where regions and countries are selected for each phase – so that any decision on where the UK and perhaps even Europe fits into that roll out plan may now need to be considered again in light of the current uncertainty - possibly pushing these further back in the queue and
- remuneration policies, such as incentives and bonus terms which may be affected by market volatility and working practices (including leave, agency worker and other rights etc, as well as the impact on confidence and productivity) that need to be reviewed on a company-by-company basis to consider comparability and equalisation.

People and tax

Movements of people and workers from the UK to the EU and vice versa, should not be much affected by changing tax regulation in the two years (or more) before withdrawal (unlike uncertainty and volatility in markets which are expected to have a significant impact). As with remuneration policies, above, there may be practical differences in the levels of staff employed in particular locations during that period and employers may desire to plan for the tax-related changes exit may bring, depending on the withdrawal arrangements. Considerations may include, for example:

- cessation of EU regulations on social security coverage and benefits, affecting particularly those working on a temporary basis outside their 'home' State. This could lead to increased social security costs, lack of benefit coverage, fragmentation of pension benefits (and increased costs for employers who could have to provide more comprehensive private medical insurance to employees), and
- changes in UK tax rules as a result of greater freedom from EU regulation in things like entitlement to personal allowances as a non-resident, pension regulation (and impact on employer covenant and funding needs/ arrangements), workers' rights and, in the financial services sector, remuneration/ bonus regulation.

Changes in UK tax policy as regards those resident but not domiciled in the UK are already in train. These likely will not be stopped or reversed, although the approach to attracting high net worth individuals to the UK and keeping them there may need to be addressed more broadly.

An interesting question has arisen about the possibility of the UK negotiating a form of freedom of movement of labour as distinct from the freedom of movement of people. That would be attractive to some of those concerned about immigration issues generally considering the uncertain status of the approximately three million EU nationals living in the UK. However, it would bring into question the position of temporary arrangements, business visitors and workers when they retire and the need to monitor working arrangements rather than merely policing a country's borders.

Indirect taxes

Of the various consumption-based taxes, customs duties and VAT are most directly affected as they are directly determined by the EU. The potential impact on customs duties is widely regarded as one of the most significant implications of a full exit from the EU.

VAT Directive (2006/112 EC) and all EU Regulations relating to VAT would cease to apply on exit. Barring any agreement to do otherwise, VAT in the UK would then become a purely domestic tax and, in the course of time, the rules may diverge from EU rules, with the UK potentially

introducing new exemptions, removing exemptions, etc, without regard to EU law. However, the effects would probably take time to materialise. There has been a lot of flexibility over the VAT rates, although there has been more political pressure recently – if the UK were free to choose its rates it likely would undertake a major consultation exercise. There is a particular issue with respect to the Mini One Stop Shop (MOSS) – the EU wide scheme for VAT on telecommunications, broadcasting and electronically supplied services supplied to private consumers in the EU – there are versions of the simplification for both non-EU businesses making sales to EU consumers and for EU businesses making sales to consumers in other Member States. Loss of this facility could result in losing business to another State.

Goods imported into the UK have customs duties set by the EU. If the UK doesn't join the EEA and there is no agreement on a separate customs union or FTA with the EU, the UK would set its own rates on exports and imports with EU countries and non-EU countries. If the UK joins the EEA, it would still set rates for transactions with non-EEA countries.

It is uncertain how much the current EU arrangements with countries with which there is no FTA agreement would guide the UK's re-negotiations. Typical examples below indicate the range of values:

- clothing/ footwear/ accessories - generally up to 12%
- cars - generally 10%
- car parts, machinery, consumer health products - generally up to 5%
- electronics - generally up to 14%
- homeware, intermediate pharma products - generally under 10%
- tobacco - cigarettes 57%

The EU also assesses a lower/ zero duty rate against goods from certain developing countries under the Generalised System of Preferences (GSP) to help foster these countries' development. The measures vary for each country and are not available for all goods imported from these countries. There will likely be continued GSP preferential treatment for such countries in the event of a full exit as the GSP regime is provided by other developed countries to developing countries and continuing the GSP will not involve the UK's negotiation of reciprocal trade benefits.

In the UK, excise duties are assessed at rates determined by the UK government. For this reason, there is no direct link between a UK exit from the EU and the applicable excise duty rates for affected industries. There will, however, be implications for the trade of excisable goods between the UK and the EU in that currently such goods can be moved under an excise duty suspensive regime in this cross-border trade. Instead, such movements will most likely be treated as formal exports and imports of excisable goods.

Direct taxes

Direct taxes are not within the competence of the EU but are the prerogative of each Member State. By unanimous agreement in the Council of the EU, all Member States can agree Directives that require them to introduce laws on direct taxes into their domestic tax systems. Exit from the EU has no direct impact on provisions that have been made in the UK tax legislation as a result of various Directives but, subject to any withdrawal or other agreement, the UK may choose to keep, adapt or remove them. There are a limited number of provisions in UK tax legislation that directly refer to the EEA. However, other Member States will no longer be bound to apply their equivalent domestic rules related to transactions with the UK other than as per the withdrawal agreement, so UK taxpayers could potentially lose various protections.

Most historic Directives relating to direct taxation afford a degree of beneficial treatment. This treatment would not apply under the EEA Agreement (although the fundamental freedoms would apply) or if no bilateral measure is agreed with potential consequences as in the following bullets.

- For periods after an EU exit, the cost to a UK company (and thereby to any ultimate parent) of investing via a subsidiary in other Member States would be higher where the UK's double tax treaties do not reduce the withholding tax (WHT) on dividends paid to the UK to zero as under the parent/subsidiary directive – examples include Germany and Italy. The UK would be free in theory to reintroduce taxes that were unlawful within the EU – e.g., full taxation of foreign dividends with credit only for actual foreign taxes paid (or income tax at source on interest and royalties) – albeit this is unlikely as it would run counter to the Treasury's promotion of the UK's international competitiveness. The same arguments would apply to the unlikely introduction by the UK of a withholding tax on dividends.
- Likewise, the Mergers Directive provides benefits not otherwise available and therefore its repeal will impact a number of multinational groups with UK and EU operations. In some Member

States the UK's exit would affect the applicability of the respective reorganisation tax law (e.g., in Germany a retroactive taxation of a tax-free contribution might be triggered). Any adjustment to the Arbitration Convention may affect some situations.

Recently, more Directives have imposed greater obligations on Member States as regards business and further proposals are in the pipeline. The UK will almost certainly continue to adhere to minimum standards agreed at the OECD for countering base erosion and profit shifting (BEPS). But elements in the EU want to go further on perceived tax avoidance measures, particularly as set out in the Commission's anti-tax avoidance package and in European Parliament discussions. Progress on some of the other proposed rules may be quicker or slower without active intervention from the UK during the withdrawal negotiations and especially following exit, although other Member States differ on their views of particular issues and the timing of implementation and UK exit could be problematic. Some of the main open Directives and a discussion of the impact of the UK's exit follow.

- The exchange of advance tax rulings and certain tax information on a country-by-country reporting (CbCR) basis to tax authorities through EU amendments to its Directive on administrative cooperation in tax matters (DAC3 and DAC4) virtually mirror OECD equivalents so are unlikely to be impacted by the UK's exit from the EU.
- The anti-tax avoidance Directive (ATAD) implements OECD BEPS recommendations as far as it concerns CFC and interest deductibility (and partially hybrid mismatches). The UK already believes it complies with the CFC recommendations and is in the process of introducing rules in the other two areas. In other EU Member States, if the UK were to be considered a low tax country the CFC rules might have to be considered. Insofar as ATAD relates to other issues, the UK already has a general anti-avoidance rule (GAAR) but would need to introduce exit taxation on a transfer of assets from a UK head office to any EU branch from 1 January 2020. With that date almost certainly after UK exit, it is uncertain whether the UK would choose to make this change. In some EU Member States, the UK leaving the EU may be a trigger event for an exit charge to crystallise.
- A draft Directive for public CbCR has been published by the European Commission. The UK government has recently supported the broad principles outlined, but may choose to adopt different rules as a result of leaving the EU. The timing is uncertain as to whether it would be required to implement the EU rules before exit. If a qualified majority of Member States were to adopt a version of the rules the UK didn't like then questions arise as to how any enforcement action would be pursued against the UK post-exit if it didn't comply pre-exit.
- Harmonisation of the corporate tax base as part of a two-stage process toward a common consolidated corporate tax base (CCCTB) will likely be formally proposed during 2016. The mandatory consolidation and apportionment across EU Member States would follow. The timing of the first CCTB stage could theoretically bring its implementation within the period the UK is still expected to be in the EU, but some may consider a delay in that stage worthwhile if the UK were likely to object to measures other States agree on. Historically the UK has appeared less willing than some other States to agree to elements of the consolidation, so this might progress more easily without the UK, albeit the UK was not the only state to express concerns.
- The EU Code of Conduct Group and the Commission is likely to agree an EU list of uncooperative tax jurisdictions in 2017. It is not yet clear what sanctions might be proposed against those jurisdictions, although the Commission has referred to the strong dissuasive effect and tools at its disposal to promote tax good governance worldwide, such as agreements with third countries and development assistance. The OECD is also working on updating its criteria in this area, so the UK may feel pressure in relation to some of its crown dependencies and offshore territories even with an exit.

The continuing application of the fundamental freedoms or otherwise would determine the UK's ability to reintroduce tax charges previously held to contravene the EU Treaty freedoms (e.g., broader controlled foreign company (CFC) rules or the 1.5% stamp duty/ SDRT charge on issue or transfer of shares to a clearance service or depositary). It would also determine the treatment by other Member States of certain transactions with the UK.

The UK has been keen to encourage and promote particular direct tax policies, which have had to comply with State aid rules. There may be more scope for the UK helping particular segments through tax policy following exit (although State aid or

similar rules would apply to the EEA option and could be part of any negotiated bilateral agreement option). For example, innovation relief in the UK could perhaps be augmented further to attract and retain businesses without the kind of cap imposed, for example, on the UK SME R&D tax relief. Comparably, the nexus restriction on the UK patent box largely follows the OECD rules rather than any EU proposals and therefore is likely to remain. Reassuringly, the current legislation for R&D relief and patent box should continue to apply with no aspects placing reliance on the UK being part of the EU. As regards innovation incentives, the kind of grant funding that the academic, public and private sectors (often collaborating on a pan-European basis) has attracted from the EU via European funding programs such as Horizon 2020 may need to be replaced, but the arguments about using funds that don't have to be paid into the EU in the first place is beyond this bulletin's scope.

There has been speculation about whether the UK's main rate of corporation tax would be reduced even further in order to attract business. Government policy under the new Prime Minister would have to be determined in this regard. There have also been a broad range of arguments about the need to raise taxes through income tax or other taxes and the impact on other austerity measures. There is a balancing act between remaining competitive and needing to raise revenues (this has always been the case but may be more acute going forward).

Finally, with regard to international direct taxation, recently the OECD has been as much, if not a bigger influence than the EU. So it is not clear how much, if any, increased flexibility there will be post-exit. The key variable is likely to remain the tax rate rather than the tax base.

The takeaway

Businesses can start assessing factors that will be relevant to their tax position on a UK exit from the EU. In most cases, immediate action is not necessary to prevent negative tax consequences but there is an urgent need to be as fully informed as possible, show awareness and calm any nerves shown by your employees, your supply chain and other stakeholders. The Article 50 trigger to begin the likely two-year countdown will need to balance the desire to provide the optimal amount of time for negotiations and the goodwill of the UK and the remaining Member States in striking a beneficial withdrawal agreement. However, it is uncertain whether this triggering event could stretch into early 2017.

The UK government has appointed a Brexit team to consider the breadth of issues that need to be considered in withdrawal negotiations and consequential UK policy changes. It has been suggested that business will be consulted in this regard and we encourage companies to engage in the process and make known their concerns and preferences on tax.

There is volatility in markets so the impact on businesses will need to be carefully considered, whether in the nature of treasury and foreign exchange management, operations or even on remuneration incentive levels. Business leaders will be expected to set the tone of calm consideration, systematic review and clarity of purpose (in tax as with other issues – as noted in our webcast of 5 July). For some there may be opportunity as well as the need to control risk.

Some of the discussions may well lead to wider policy debate and more long-term directional change. While focusing on the present and short-to-medium term aspects of cost control etc, businesses should also think about longer-term strategy and the tax impact.

Let's talk

For a deeper discussion of how these issues might affect your business, please call your usual PwC contact. If you don't have one or would otherwise prefer to speak to one of our global specialists, please contact one of the people below:

Global, UK & EU Tax Policy Contacts

Stef van Weeghel, *Amsterdam*
+31 (0) 88 7926 763
stef.van.weeghel@nl.pwc.com

Phil Greenfield, *London*
+44 (0) 20 7212 6047
philip.greenfield@uk.pwc.com

Aamer Rafiq, *London*
+44(0)20 721 28830
aamer.rafiq@uk.pwc.com

Edwin Visser, *Amsterdam*
+31 (0) 887923611
edwin.visser@nl.pwc.com

Pam Olson, *Washington*
+1 (202) 414 1401
pam.olson@us.pwc.com

Alex Henderson, *London*
+44(0)20 780 46370
alex.henderson@uk.pwc.com

Stella Amiss, *London*
+44(0)20 721 23005
stella.c.amiss@uk.pwc.com

Jonathan Hare, *London*
+44 (0)20 7804 6772
jonathan.hare@uk.pwc.com

Bob van der Made, *Brussels*
+31 88 792 36 96
bob.van.der.made@nl.pwc.com

Other contacts

International Tax
Panny Loucas
+44(0)20 780 40365
panny.loucas@uk.pwc.com

Tax Litigation (PwC Legal)
Peter Halford
+44(0)20 721 38376
peter.halford@pwclegal.co.uk

Innovation Incentives
Angela Browning
+44(0)1509 60 4274
angela.browning@uk.pwc.com

Indirect Taxes
Chris Orchard
+44 (0) 20 7213 3238
christopher.p.orchard@uk.pwc.com

VAT
Martin Blanche
+44 (0) 20 7213 8347
martin.j.blanche@uk.pwc.com

Customs Duties
Matthew P Clark
+44 (0) 207 212 4143
matthew.p.clark@uk.pwc.com

Excise duties
Johnathan Davies
+44 (0) 20 7212 1208
johnathan.c.davies@uk.pwc.com

Immigration (PwC Legal)
Julia Onslow-Cole
+44(0)20 780 47252
julia.onslow-cole@pwclegal.co.uk

Employee mobility
Ben Wilkins
+44(0)20 721 24096
ben.wilkins@uk.pwc.com

Pensions
Richard Cousins
+44(0)20 780 43119
richard.cousins@uk.pwc.com

SOLICITATION

© 2016 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 195,000 people who are committed to delivering quality in assurance, tax and advisory services. Find out more and tell us what matters to you by visiting us at www.pwc.com