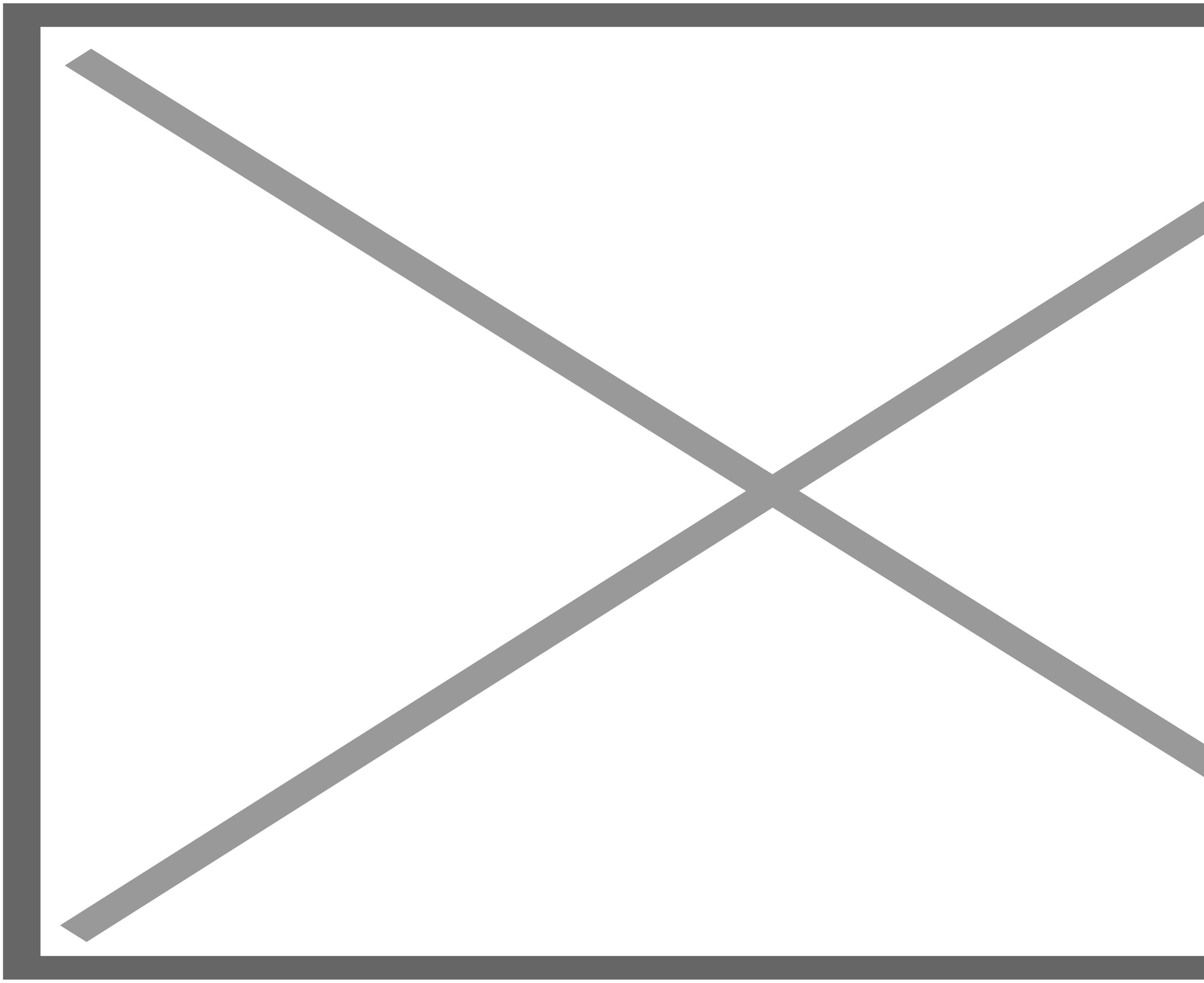
Steady as she goes

Indirect Tax



01 October 2016

Maric Glaser examines how Brexit may affect VAT

Key Points

What is the issue?

The decision to leave the European Union will inevitably have consequences for VAT (and other taxes).

What does it mean to me?

There will be some changes that affect how businesses account for VAT. Most are likely to be minor.

What can I take away?

Businesses should consider the implications of Brexit in their planning during the run up to the actual event.

In his article on the tax implications of Brexit, Bill Dodwell (Tax Adviser, August 2016) dealt with the high level issues that will need to be dealt with e.g., the interpretation of law that was introduced to fulfil EU law and therefore was subject to EU law principles of interpretation.

We will not know what Brexit will look like for some time. The Prime Minister, Mrs May, said in Rome that she was seeking a ‘bespoke’ British relationship with the EU, which could curtail the free movement of people while maintaining the maximum possible access to the single market. It is understood HMRC are already considering how the UK could remain part of the VAT union, in the same way that some countries are in the customs union but not the VAT union.

What to do about VAT?

VAT is just one of the issues that will need to be dealt with as part of formulating the shape of Brexit. It would be a safe bet to assume that it will be business as usual, at least until a decision is taken on the shape of Brexit, and perhaps even into the future.

One question that the CIOT was asked during the referendum campaign was ‘Can we do away with VAT?’ The simple answer is ‘Yes’ in principle, but for reasons stated below, it is unlikely. In time, political objectives may shape the VAT system such that it is increasingly disharmonised from the EU system unless the VAT union continues to impose the predominance of EU law.

The UK introduced a VAT system to comply with its obligations when joining what was then the European Common Market. The legal implications of Brexit on the VAT system will be considered in an upcoming issue.

In the 2015/16 fiscal year, taxes collected by HMRC (per their annual report) amounted to £536.8bn in the UK. Income tax generated 32% of that, VAT – 22%, NIC – 21% and Corporation tax – 8%. There is no prospect of any other tax replacing the £116 bn revenue generated by VAT if it were abolished. That in itself guarantees the role of VAT in the British tax system post Brexit.

There are further reasons VAT is unlikely to be replaced. First, more than 160 of the 190+ countries in the world use it. This is no coincidence. VAT (or its local equivalent such as GST, TVA etc) is probably one of the most efficient taxes in terms of ease and efficiency of collection. The OECD estimates that such taxes generate on average 20% of government revenues.

Next, there is the immense cost of introducing a new tax e.g., both HMRC and businesses would have to train staff to deal with a new tax and there would be the cost of developing new systems.
It therefore seems unlikely that the UK government faced with other priorities would contemplate abolishing VAT, or even making significant changes to it.

The Brexit issues for VAT in summary if the UK leaves the EU

In the event that the UK leaves the EU and does not remain in the VAT union, it will become a ‘third country’. As such, it will have to deal with the other 27 EU Member States like any other non-EU country does currently. Second, there would be the likely repeal of the European Communities Act 1972 which would require consequential changes to primary and secondary legislation. In particular there will be no difference in the treatment of goods and services supplied to other EU Member States from the UK (and Isle of Man), or vice versa, as compared to other countries outside the EU.

Third, it can be expected that some optional changes will be effected that could not be effected under the constraints imposed by the EU Treaties and VAT Directives. This could include opportunities for simplification, some of which are examined below.

The impact of exit from the EU on VAT

EU law creates a special regime to deal with transactions between taxpayers in two EU Member States, compared with the treatment of a ‘third country’.

Because the current EU VAT system is likely to continue for the remaining EU member states, the position after Brexit is largely predictable. Some limited examples may include –

- Goods sent from businesses in the UK to EU Member States will be treated as exports rather than despatches. Whilst there should be no financial impact, the compliance obligations will change, such as no longer having to complete EC Sales Lists and Intrastats;
- Similarly, services provided by businesses in the UK to EU Member States will also change, as these will be ‘exported’ services, rather than provided intra-community. These may have a financial impact since some financial and other services may no longer be treated as exempt from VAT, but become outside the scope of UK VAT or specified supplies, with the right to recover input VAT. As this could be a very significant change, the UK will need to consider how such supplies from the UK into the EU should be treated. Reporting obligations for UK suppliers will also change, such as no longer having to prepare EC Sales Lists;
- With regard to goods bought from EU suppliers, these will become imports rather than acquisitions, and subject to the clearance procedures currently in place for non-EU imports. Services bought in from EU suppliers will largely remain subject to the ‘reverse charge’, as now.
- EU businesses providing electronic services to consumers in the UK will, as things currently stand, no longer be able to use the Mini-One-Stop-Shop (MOSS) to account for output tax on relevant B2C transactions; they may have to register for UK VAT in the UK, perhaps as a ‘non-established taxable person’. Conversely, UK businesses providing electronic services to consumers in the EU will have to use the ‘non-union’ scheme, which entails registering for VAT in another EU member state and accounting for VAT on certain B2C supplies within the EU from that Member State. The take up of MOSS in the UK has been one of the highest in the EU, and there are proposals to extend the MOSS to supplies other than electronic services, so the inability to operate MOSS may put UK businesses at a disadvantage to their EU counterparts;
- The legislation dealing with refunds of VAT will presumably also change to repeal legislation allowing refunds under the Directive 2008/9/EC (the old ‘Eighth Directive’ refund scheme);
- A rather minor but welcome benefit for some travellers will be that as they will no longer be EU residents, they should be entitled to make use of duty free allowances when buying goods in other EU member states.

Apart from changes possibly affecting the incidence of tax, the issue of co-operation in the field of tax administration will also need to be considered. For example, will the UK be able to enter into similar instruments to retain the benefits of administrative co-operation and mutual assistance directives that require member states to help each other collect taxes and prevent fraud? We would hope so.

Changes that need to be made to UK VAT

In the UK, legislative change will be inevitable to deal with the fact that the status of the supplying or recipient country (i.e., EU or non-EU) may no longer be relevant.

As noted, there is very little wrong conceptually with the current VAT structure (although the EU is proposing some significant change in its VAT Action Plan). Thus, it is unlikely that radical VAT change will be high on the list of things that a UK government, freed of the 'shackles' of the VAT Directives, will want to change.

Some changes will, however, be forced upon the UK since, among other things, VATA 1994 is strewn with references to the EU that need to be amended. This will require amendment or repeal.

More difficult to judge is what happens to UK law that has come about because of the UK losing a case in the Court of Justice of the EU, and the principles of EU law which underpin many of these decisions.

Consider for example the case of *Littlewoods*. Part of that case concerned how interest due to the taxpayer should be calculated where it had been determined that it had overpaid tax. The Court of Justice considered that the remedy had to comply with the principles of equivalence and effectiveness, which might mean that compound rather than simple interest was due.

The risk of avoidance, abuse and evasion will continue to be an issue. In the case of *Teleos plc and ors v CCE* (C-409/04), the Court of Justice held that a supplier, who was involved in a fraudulent chain of transactions was still entitled to exempt inter-community transfers of goods from VAT provided he met normal conditions and had taken all reasonable steps to ensure that he was not participating in the fraud. In reaching its conclusion, the Court took account of freedom of movement goods while accepting that Member States can impose reasonable compliance requirements on taxable persons. Brexit could lead to a change in the nature of evidence needed to prove that goods have been exported.

However, consider also the VAT Tribunal decision in *Rapid Sequence* [TC02826]. The Tribunal applied a 'conforming interpretation' and interpreted the UK legislation in accordance with EU law and concluded that the company's supplies were standard rated, but accepted that if it had not done so, it would have found for the taxpayer that the services were exempt from VAT.

In each of the above cases, would the repeal of the European Communities Act alter the position? This will be one of the issues to be dealt with in a future article.

Retaining the best of EU law

There are a number of fundamental principles of EU law that are likely to survive notwithstanding Brexit. They include the principles of –

- Legal certainty
- Neutrality
- Proportionality

- Legitimate expectation

The most important to business in both the VAT and non-VAT context is probably legal certainty. Most business want to know what their rights and obligations are and to comply with the law.

Tax neutrality is a fundamental principle of VAT worldwide, as recognised in the OECD's VAT/GST guidelines. Those guidelines recognise that the concept of tax neutrality has a 'number of dimensions'. They provide that:

- 'the burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation'; and
- 'businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation'.

The VAT Directives provide a large measure of both certainty and neutrality for taxpayers in the EU by largely harmonising the scope of the tax and by limiting the extent that Member States can derogate from the common theme. Although the UK will not be bound by the harmonised system, it may nevertheless retain it.

After Brexit, some principles may not survive unless they exist in another form e.g., the World Trade Organisation rules might prevent local supplies of goods and services being given preference over imported supplies. The OECD is developing guidelines on VAT systems which may become significant in the future.

Nevertheless, legislative acts can be repealed or amended, a consequence of a Parliamentary democracy.

Finally, preventing avoidance, abuse and evasion has been a central part of the VAT system in the EU. HMRC has relied in part on EU jurisprudence that allows it to prevent abuse without any specific legislation. The old debate about whether the *Ramsay* principle applies to VAT will be resurrected. There will invariably be rules to prevent avoidance, abuse and evasion. The government may well apply the GAAR for VAT?

Optional changes

Taxes are sometimes used to influence behaviour e.g., to tax unhealthy foods and provide relief for certain types of expenditure such as energy saving materials. Some of these approaches are prohibited by the Principal VAT Directive. Being outside the EU will provide greater flexibility. For instance, there have been suggestions that VAT on energy supplies will become zero-rated. That will come at a significant cost – ONS statistics show that there are 27 million households in the UK spending an estimated £100 a month on energy. That totals over £30 bn, meaning that VAT at 5% paid on those bills must have exceeded £1.4 bn.

Some changes can be effected by relatively simple amendments to existing VAT legislation. For example, the 'tampon tax' issue could be resolved by extending the UK's zero-rates in VATA 1994, Schedule 8.

It is of course not only rates that could change; the government could also alter the scope of existing exemptions without resorting to new primary legislation. However, VAT systems work best if exceptions from the standard rate are kept to a minimum, so the political and economic impact of any change would need consideration.

Some other possibilities arise e.g .,EU Member States cannot have more than one VAT-type tax. An exit from the EU theoretically allows other turnover taxes to be introduced.

Among the issues that have been examined by the EU in the past has been the taxation of financial services; many of which are currently exempt from VAT, but some are taxable, and the difficulty in correctly classifying such supplies is typified by the recent litigation around card handling fees. There have been arguments for taxing certain financial services and it would certainly be possible to change the structure of taxation of such services.

Another possible area for change is the treatment of cost sharing, which provides opportunities for efficiencies in business and can also help small and medium businesses access scarce resources at an acceptable cost. There may be scope to relax the strict conditions that limit the exemption, to enable it to operate more effectively.

Other issues

Tax is not just a matter of law; it provides a framework for the relationship between the State and the taxpayer. EU law has had a significant effect on how governments and their tax collectors can deal with taxes and taxpayers. Freedom from the constraints of EU law may effectively give greater powers to HMRC.

Thus, in some non-EU countries, a court finding for the taxpayer might be met with a swift change in legislation that would not be possible under EU law. The UK government has of course resorted to legislation to reverse a court's decision which is not governed by EU law e.g., the *Waste Recycling Group Limited* [2008] EWCA Civ 849 judgment of the Court of Appeal on landfill tax.

Given the greater freedom to make law, one can expect an increase in lobby groups saying why VAT should be used to promote one behaviour or deter another or to support one group of people and not another. For most VAT specialists, this potentially defeats one of the primary purposes of VAT which is to have a very broadly based, simple tax with limited exceptions.

Conclusion

Brexit potentially involves many fundamental issues. Changes to the VAT system are therefore unlikely to be high on the agenda for ministers. It will continue to apply until, and if indeed the UK leaves the EU. However, the current UK VAT legislation is so intertwined into EU law that a raft of detailed changes will inevitably be required. Practitioners will need to get to grips with them. Even if initially things remain the same, there will inevitably be significant change in the future unless Brexit involves retaining the current VAT system, which it may well do.

The author wishes to acknowledge the very helpful comments on this article by Tarlochan Lall of Monckton Chambers. Tarl is a member of the Indirect Taxes Sub Committee.