Avoiding the post-Brexit freeze

Indirect Tax



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Tarlochan Lall provides an update on the post-Brexit VAT and customs landscape

Key Points

What is the issue?

Following Brexit, the UK will become a ‘third country’. Unless agreement is reached with the EU, essentially the VAT and customs duties rules and procedures that apply to goods moving into and out of the EU will apply to movements between the EU and

the UK

What does it mean to me?

Businesses must consider the effect of Brexit in the context of their own circumstances.

What can I take away?

Even if there is an agreement, businesses will need to deal with new rules seeking to relieve burdens the UK would otherwise have as a third country

The white paper on ‘The Future Relationship between the United Kingdom and the European Union’ published on 12 July 2018 declares that: ‘The UK is leaving the EU, and as a result will leave the Single Market and the Customs Union…’

The aim of this article is to provide a dispassionate overview assessment of what is proposed in the white paper and its impact on VAT and customs duties post Brexit.

The white paper recognises that: ‘…”nothing is agreed until everything is agreed”, the Withdrawal Agreement and the framework for the future relationship are inextricably linked – and so must be concluded together’

The proposed transition period to 31 December 2020 is conditional on the Withdrawal Agreement being agreed. An additional condition of agreement on the framework for the future relationship has been added.

The ‘core’ proposal is ‘the establishment by the UK and EU of a free trade area for goods’. Services, which form circa 80% of the UK economy, would be dealt with under: ‘new arrangements for services and digital, recognising that the UK and EU will not have current levels of access to each other’s markets in the future.’

A new arrangement is proposed rather than adopting a known existing model, such as the agreement on the European Economic Area between the EU, its member states and States of the European Free Trade Area. The proposal is ambitious. There is a real risk of failure to reach agreement simply because it may not be practically possible to achieve the necessary agreement in the time available exposing the UK to a hard Brexit on 29 March 2019.

The EC's communication of 19 July 2018 advises all businesses, and SMEs in particular, that: 'All stakeholders concerned should prepare for a situation where shipments of goods from and to the United Kingdom are subject to customs procedures and controls.

The government also plans to issue a range of papers in August and September on how businesses should prepare for a hard Brexit.

Key features of the proposal for custom duties

The new free trade area for goods would be governed by a common rulebook, which 'would be legislated for in the UK by the UK Parliament and the devolved legislatures'.

The proposed free trade area would have:

- a phased introduction of a new Facilitated Customs Arrangement (FCA) without the need for customs checks and controls between the UK and EU 'as if in a combined customs territory'. Under the FCA, goods entering the UK would be subject to:
    - EU customs processes, common tariffs and trade policy when destined for the EU. Correct EU duties having been paid, the goods would move freely from the UK to the EU; and
    - UK customs processes, tariffs and trade policy when destined for consumption in the UK. The UK would control these and not be bound by EU rules on them;
- an agreement not to impose import tariffs, quotas or routine requirements for the rules of origin for goods trade between the EU and the UK; and
- a common rulebook for manufactured goods and agriculture, food and fisheries products which will cover 'only those rules necessary to provide for frictionless trade at the border'. This relates to regulatory matters for placing goods on the EU and UK markets.

The scheme for charging tariffs/duties would apply:

- the UK tariff if the goods are destined for the UK and the EU tariff if destined for the EU where the destination can be 'robustly demonstrated by a trusted trader'. This is likely to be relevant to finished goods. There is no information on the trusted trader scheme and whether, for example, SMEs will qualify;

- the higher of the UK and EU tariff where the destination cannot be ‘robustly demonstrated at the point of import’. Establishing entitlement to lower tariff would give entitlement to repayment of overpaid duties from the UK government. This is most likely to be for unfinished or intermediate goods although an estimated ‘96 per cent of UK goods trade would be most likely to be able to pay the correct or no tariff upfront’ so the repayment mechanism would be an issue for the balance of 4% of trade.

VAT and other taxes

Customs duties on most goods coming into the EU are below 10%, (the exceptions being cars at 10% and agricultural products that often bear higher tariffs). The standard rate of VAT is 20% (though lower rates apply to certain products and food benefits from zero rating). Excise duties can be even higher.

One paragraph covers VAT and Excise duties, namely: ‘To ensure that new declarations and border checks between the UK and the EU do not need to be introduced for VAT and Excise purposes, the UK proposes the application of common cross-border processes and procedures for VAT and Excise, as well as some administrative cooperation and information exchange to underpin risk-based enforcement. These common processes and procedures should apply to the trade in goods, small parcels and to individuals travelling with goods (including alcohol and tobacco) for personal use.’

Although the free movement of people will end, the UK will seek reciprocal mobility arrangements to essentially support business providing services, tourism and to facilitate mobility for students. Such reciprocal arrangements will seek to ensure workers only pay social security contributions in one state at a time.

A common rulebook on state aid would be enforced by the UK Competition and Markets Authority. Finally ‘the UK’s proposal for its future economic partnership with the EU would not fetter its sovereign discretion on tax, including to set direct and indirect tax rates, and to set its own minimum tax rates.’

The customs union

The core features of the customs union the UK will be leaving:

- allow goods to move within the EU free of customs duties;

- subject goods entering the EU to a common tariff, namely common rates of import duties and the classification of goods (the combined nomenclature). The combined nomenclature is based on a harmonised system established by the International Convention on the Harmonised Commodity Description and Coding System which is the basis for the classification systems of most nations throughout the world;
- require the member state into which goods first enter the EU to collect the customs duties and remit them to the EU net of 25 per cent of the duty to cover costs. Customs duties do not apply to services;
- give the EU exclusive competence in relation to the customs union and a common trade policy, including in relation to services. The EU negotiates and enters into trade agreements with non-EU states or international organisations (FTA). The FTAs may provide for preferential tariffs for imports and exports;
- have common customs procedures which police goods moving into and out of the EU on grounds of public policy, public security, the protection of health and life of humans, animals or plants, or the protection of national treasures;
- provides simplifications for Authorised Economic Operators (AEO) within the customs union;
- gives ‘EU content’ to goods originating in the UK incorporated into goods in another EU member state for export out of the EU allowing them to benefit from any preferential tariffs agreed by the EU with third countries; and
- allows the movement of alcohol, tobacco and energy products under the Excise Movement and Control System (EMCS) without payment of duty until they reach their final point of consumption.

Most of these are fiscal measures affecting businesses. Simplifications such as AEO authorisations issued by the UK and EMCS duty suspension will cease to apply within the EU absent an agreement.

Customs union to the WTO system

Exit from the customs union would leave the UK subject to the World Trade Organisation (WTO) system.
The WTO’s key instrument is the Marrakesh Agreement of 1 January 1995, which provides rules for world trade, a dispute resolution mechanism, and matters concerning trade policy and agreements between states. The dispute resolution mechanism does not give businesses direct rights: they have to enforce rights

through their governments.

The UK is a member of the WTO like all EU member states. The EU's exclusive competence under the customs union means that WTO provisions have been negotiated and agreed at the EU level, including the combined nomenclature and preferential rates of duties for imports and exports. The UK will lose the benefits of those.

The cardinal feature of the WTO system is the principle of non-discrimination at two levels, namely:

- Most Favoured Nation (MFN) treatment, namely equal treatment of WTO members for 'like' products, i.e. non-discrimination, at borders; and
- National Treatment, namely equal treatment between imported and domestic like goods, i.e. non-discrimination inside borders.

Under the WTO system, MFN rates of duties/tariffs, known as bindings, are maximum rates of duties countries can apply. Individual countries can and often do set lower rates of duties (MFN standard rates) under FTAs. Under the MFN principle, all WTO members must be given the same MFN standard rates. The EU's FTAs with various countries provide for lower rates to apply, in cases for agreed quotas, i.e. imports up to specified levels of imports. Qualification for lower rates of duties on imports and exports turns on appropriate classification and rules of origin to ensure that the goods have their origin in the country entitled to the preferential rates.

The EU and UK notified the WTO in October 2017 that they would follow a cooperative and transparent approach on necessary adjustments arising from the UK's withdrawal from the EU. The existing quotas will need to be apportioned between the EU and the UK so as to '*maintain the existing levels of market access available to other WTO members*'.

The Taxation (Cross-border Trade) Bill (Customs Bill) provides for the creation of a new customs system. Regulations will establish a system of customs tariffs, classification of goods (in place of the EU combined nomenclature) and codes. That Bill also allows preferential rates to be applied to goods originating from specific countries under FTAs and also to give unilateral preferences to imports from developing countries.

Although it is open to the UK to adopt existing classifications, codes and rates, the UK would have to negotiate and agree tariffs with WTO members and the EU that apply to UK exports to those countries. The UK cannot control what other countries do. Whether and how quickly agreement is reached would depend on the political will of the other WTO members and their cooperation. Each member is entitled to ensure that the arrangements with the UK are in its interest, which can delay agreement. As agreement with WTO members will not be secured by March 2019, securing a transition period is vital. A hard Brexit would expose importers and exporters to the loss of preferential tariffs and they would be subject to MFN standard rates until the UK is able to secure any preferential rates. Most significantly, EU members would apply the common tariff to goods moving from the UK to the EU rather than nil duties within the customs union.

The VAT area

The VAT area consists of countries which adopt common rules on VAT. The European Commission's 2016 communication entitled 'An action plan on VAT: Towards a single VAT area – time to decide' introduced the concept. In May 2018, the Commission published proposals for amending the VAT Directive to create the definitive destination system, which is intended to take effect from 1 July 2022. That definitive system will replace the current transitional system.

B2B movement of goods are free of VAT, with the recipient accounting for acquisition VAT under the reverse charge mechanism under the current transitional system. VAT will become due at borders if the UK leaves the VAT area.

Uncertainty in the white paper whether UK will leave the VAT area was resolved by amendments made to the Customs Bill on 16 July 2018 which sought to ensure that the UK will be leaving the VAT area. The white paper also makes clear that '*rights stemming from the future relationship would be enforced in the UK by the UK courts and in the EU by EU Courts*'. The VAT Directive and other EU legislation will no longer apply to the UK. However, it is accepted that the rules that apply should be given 'consistent interpretation' and the UK courts 'could take into account relevant case law' of the EU.

Under the destination system from 2022, suppliers will have to charge VAT on B2B cross-border goods supplies at the destination country's VAT rate. There will be a single intra-Union supply, rather than an exempt dispatch and taxable acquisition.

Although there will be significant VAT cash-flow costs for businesses, the VAT would still be accounted for through VAT returns. VAT administration will be eased by expanding the mini one-stop shop (‘MOSS’) introduced for telecommunication, broadcasting and electronic services. Non-EU businesses will be able to avoid multiple EU VAT registrations by a MOSS registration in one EU member state. Compliant business may be able to secure Certified Trader Status (CTS) to allow them to continue to account for acquisition VAT and avoid the cash-flow implications of having to pay the supplier.

Businesses and advisers will have to manage changes in law following Brexit in 2019 as well as any changes needed to adapt the new UK regime to the destination system.

Summary of the post Brexit landscape

Following Brexit, the UK will become a ‘third country’. Unless agreement is reached with the EU, essentially the VAT and customs duties rules and procedures that apply to goods moving into and out of the EU will apply to movements between the EU and the UK.

Even if there is an agreement, businesses will need to deal with new rules seeking to relieve burdens the UK would otherwise have as a third country. It appears from the white paper that there could be a transitional period and a separate phasing in period for the FCA, although it is hoped there would only be one combined period to avoid even more complications.

Businesses must consider the effect of Brexit in the context of their own circumstances. It will be necessary to consider any existing contracts to assess the impact on rights and obligation and whether they can and should be changed in advance of Brexit.

Contingency planning is essential if businesses want to avoid paralysis next March.