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AGE OF UNCERTAINTY

Alex Tostevin discusses the future of VAT after the UK has left the EU.

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Age of uncertainty

Goodbye substance, hello form? **ALEX TOSTEVIN** considers what VAT might look like after Brexit.

Following the outcome of the EU referendum, much has been said about the possible implications for direct tax, such as the loss of the use of the Parent-Subsidiary Directive and the Interest and Royalties Directive. There has been little commentary on what this means for VAT – the EU-wide tax that each member state is required to implement in compliance with the VAT Directive (2006/112/EC). This legislation is supplemented by further EU directives and regulations together with more than 40 years of jurisprudence from the Court of Justice of the European Union (CJEU), previously the European Court of Justice (ECJ).

Until the UK leaves the EU, which is unlikely to be for at least two years, there should be no fundamental change in UK VAT law, given that it must continue to be consistent with EU VAT law.

When the UK leaves

It is impossible to give an honest answer to the question of 'what happens when the UK leaves the EU?' without the benefit of a crystal ball.

Given the Leave campaign's determination to bring back the UK's sovereignty, it would be a slightly odd result (although not impossible) to find the UK adopting a regime that requires the country to adhere to EU VAT or other law. With this in mind, let's proceed on the basis that, once we have left, EU law will cease to have any application on our domestic VAT rules.

Some have suggested that, after withdrawal, the UK could abolish VAT or introduce new exemptions for supplies that are currently VATable. Either of these scenarios could be true, but the reality is that a form of VAT will remain given the importance of its revenues to the Exchequer. In Budget 2016, VAT was expected to raise £138bn. This was second only to the income tax haul and nearly £100bn more than the total corporation tax receipts, which were expected to yield £48bn. VAT yields a staggering amount and demonstrates its importance to the government. Consequently, from the perspective of its spending commitments and revenue generation, the government must ensure that VAT features as one of the top items on its agenda together with financial 'passporting' and free trade agreements.

Losing the constraints imposed on UK VAT law by EU law is a double-edged sword. It brings the advantage of flexibility to business, but the disadvantages of uncertainty and complexity, as well as the risk of additional turnover taxes (such as new insurance taxes) that EU law prohibits.

The key point here is that any changes should be introduced gradually to allow businesses time to adapt. It is critical that amendments minimise implementation costs and do not add excessively to the already significant compliance burden imposed by VAT.

KEY POINTS

- VAT is an EU-wide tax supported by 40 years of legislation and jurisprudence.
- If sovereignty is to be regained, why should EU law continue to apply?
- VAT could be used as a social planning tool and to give preference to specific business sectors.
- The loss of the refund procedure could add to VAT compliance burdens.
- Would an overstretched HMRC be able to deal with significant changes to the VAT regime?

What does this mean?

After the UK leaves the EU, it is likely that the direct effect and direct applicability of any EU law will fall away. This will include all of the ECJ and CJEU jurisprudence. The other noticeable loss will be the fundamental principles of equal treatment, equivalence, proportionality, fiscal neutrality, and non-discrimination. Taxpayers often rely on these principles when taking legal action against HMRC. This will place UK VAT law in a peculiar position.

For example, a taxpayer litigating against HMRC may need to run a different VAT analysis (or end up having different outcomes) for the periods before and after Brexit, without there having been any substantive changes to the wording of the domestic legislation or facts at hand. Of course, the UK would be free to legislate that historical UK VAT law for periods before Brexit should be interpreted as if EU law never existed. However, this would lead to many difficulties and potential domestic challenges such as a claim under the Human Rights Act (although this could also be abolished), a claim for restitution, or one arising out of legitimate expectation. It could also raise uncertainty within HMRC because taxpayers may be able to bring claims for historic overpaid or under-recovered VAT when the taxpayer would have had no claim under EU law.

The hope is that a business-friendly administration will make any transitional period as smooth and painless as possible to avoid long periods of protracted litigation.

There may also be confusion as to what happens when a question of EU law arises in relation to a pre-Brexit period after departure because, at that point, the UK will (presumably) no longer be able to make references for guidance and determination to the CJEU.

Areas of uncertainty

The UK will have the right to dictate which supplies are subject to exemptions, the reduced rate or the zero rate. Government could therefore give preference to particular sectors (such as renewable energy) and use VAT as a means for social planning purposes.

There could also be a degree of uncertainty on what constitutes a 'business' for VAT purposes, especially in the holding company, charity, partial exemption, and cross-border supply areas. This area has attracted much litigation over the years at ECJ and CJEU level and it is impossible to predict what the government would try to do here.

There is no UK legislation governing the rules relating to single and composite supplies: the underlying principles are instead developed from ECJ and CJEU cases such as *Card Protection Plan Ltd v CCE* [1999] STC 270 and *Levob* ([2006] STC 766). Quite how the UK courts will approach these questions is again entirely unclear and perhaps structures that pre-dated these cases might become viable again.

ATTRACTION AND INTERVENTION

What is the force of attraction?
Force of attraction shifts the identity of the person who must pay the VAT. It provides that a business established in the same territory as their customer must account for any local VAT even where the service is supplied by an overseas establishment of the supplier; usually, the customer would account for any local VAT when a supply is made to it from overseas.

What is intervention?
Intervention applies where a business provides a service to a customer in a different territory and the supplier has a fixed establishment in the customer's territory which 'intervenes' in the supply. The 'intervention' means the supplier's local establishment must account for any local VAT (and not the customer as would usually be the case).

VAT grouping is yet another area with ongoing uncertainty. For example, the UK grouping rules are currently incompatible with EU law for various reasons – among these, they only allow body corporates to join a VAT group. The UK is consulting on how to change these rules to correct incompatibilities. Will it now ignore this – and risk potential litigation – or will it introduce the required changes in any event?

Good and bad news

Some good news is that the often neglected (or forgotten about…) force of attraction and intervention rules that were introduced through the back door will be no more (See ***Attraction and Intervention***). However, they will continue to apply throughout the EU and the UK will need to be careful that double taxation is not an issue for businesses when dealing with the union. In this respect, the UK may find itself having to adhere, somewhat uncomfortably, to the place of supply rules as they are enacted in the EU. This may be necessary simply to avoid the risk of double taxation (where VAT is borne by both the supplier and the recipient of a service or goods) which would make international structures with a UK element less competitive.

One item of bad news will be the loss of the Eighth Directive refund application procedure with its new electronic format. UK companies will find themselves having to file Thirteenth Directive refund applications in each local jurisdiction. This will certainly add to the compliance burdens for these companies.

The anti-abuse doctrine in *Halifax plc v CCE* [2006] STC 919 will fall away and it is difficult to say what, if anything, will replace it. That said, the recent movement to extend the DOTAS regime to VAT may be a precursor to a similar extension of the GAAR in the same direction. The Halifax doctrine has generally nipped VAT avoidance structures in the bud and the UK has so far failed to provide anything that works as effectively for direct tax purposes, given the rafts of new direct tax anti-avoidance legislation introduced year after year.

The interpretation of the transfer of a going concern (TOGC) rules will also raise many questions, given that the UK legislation is drafted extremely narrowly, yet the interpretation has been broadened in light of EU jurisprudence. For example, will we see a return to the pre-*Robinson* ([2012] UKFTT 360 (TC)) days where the grant of a sublease could not be a TOGC?

To the extent that either Northern Ireland or Scotland (or even London…) somehow manages to remain in the EU, this will give rise to a divergence of VAT rules between these areas and the rest of the UK. This may also see the introduction of border controls and import and export formalities.

Set out below are some of the other innumerable questions and points that might arise in relation to a couple of key sectors.

Financial services and insurance

The good news is that, without the restriction as to what can and cannot be exempt for VAT purposes, the UK could enter into a golden era in the financial services and insurance sector. For example, government could work with industry to reduce outsourcing costs by up to 20%, thus promoting the UK as the world's leading centre for outsourcing, fintech and insurtech.

However, would the government have the foresight to adopt such a proposal or would it focus instead on the quantum of any 'lost' VAT? Without the influence of EU law, the UK could retain its wide insurance intermediary exemption which is at present incompatible with EU law. This would be welcomed by the insurance industry, especially as it looks to digitisation and insurtech.

One other topical issue that could give rise to interesting questions is the 'payments exemption' and whether some payment processing services will be regarded as exempt from VAT or taxable. For example, after Brexit would the law revert to a broader exemption as it stood at the time of *CCE v FDR Ltd* ([2000] STC 672, CA) and *Bookit Ltd v CRC* [2005] STC 1481? A broader interpretation might encourage an uptake in structures availing of the exemption. Alternatively, would the exemption remain narrowly drawn as has been the case since *HMRC v Axa UK plc* [2010] STC 2825, *Everything Everywhere Ltd v HMRC* [2011] STC 316, *Bookit Ltd v HMRC* (C-607/14), and *HMRC v National Exhibition Centre Ltd* (C-130/15)?

> ***"Any changes must be introduced in the least damaging way so businesses incur minimal cost and can plan, budget and spend accordingly."***

Outsourcing and competition

The UK has always looked on outsourcing relatively more favourably than other EU jurisdictions – a bone of contention when the shelved insurance and financial services directive was being negotiated. Therefore, it would not be surprising if the UK extended the existing VAT exemptions to capture the outsourcing of specific elements of exempt financial services and insurance transactions to help foster innovation and development in these sectors.

In effect, this would be legislating the CJEU case law principles from *Sparekassernes Datacenter v Skatteministeriet* [1997] STC 932 and *GfBk v Finanzamt Bayreuth* (C-275/11). UK businesses may also find themselves with a VAT advantage if the UK were to treat any supplies of financial services or insurance as 'specified supplies', thus allowing VAT recovery where it would currently be disallowed. This may be a bit of a stretch, but would go some way to encouraging a competitive, dynamic domestic VAT system.

The UK should also think long and hard about whether it is time to soften its reluctance to broaden the scope of the management of special investment funds exemption. This is because the competition with the EU will only become fiercer and one of the key requirements to compete with the likes of Ireland, Luxembourg and the Netherlands (for example on products such as securitisation and collateralised loan obligation structures, and in relation to private equity or fund structures) is an even playing field where such jurisdictions already have wide exemptions. Further, widening the exemption may assist with various asset classes being brought back onshore if the UK loses its ability to operate the 'passport' regime, and EU structures lose the ability to market to UK investors.

Cross-border trade in goods

At first glance, there are potential immediate benefits to UK/EU cross-border trade, such as no longer needing to adhere to Intrastat or sales list rules, but it is unclear as to the regimes that might replace these. In particular, given that the acquisitions regime would need to be abolished, presumably it would be replaced with a regime of imports and exports that could significantly increase costs, complexity and paperwork and, perhaps, customs duties. Again, we must wait and see.

What should the government do?

The government needs to put the economy first and resolve the uncertainty as soon as possible. Any changes must be introduced in the least damaging way so that businesses incur minimal cost and can plan, budget and spend accordingly.

The focus must be on boosting trade across both the goods and services sectors and promoting economic growth. At the same time, it would be advantageous to cut red tape and bureaucracy, minimise paperwork and increase efficiency.

Given how VAT works, a holistic approach must be the most sensible way forward because it is entirely different from direct taxes and cannot be interpreted in the same way. For example, it is not possible to look at a single element of a transaction in isolation; there is a need to understand the underlying substance of the commercial arrangement and how each piece of the puzzle fits together.

For this reason, one would think that adopting a form over substance approach will not work. Ironically, if form *was* preferred we may find that structures that fall foul of the existing *Halifax* abuse doctrine, for lack of economic reality or otherwise, might overnight become compliant with the UK law. A form over substance approach would be a very odd result and such a change could involve much upheaval for businesses because they would have to learn a new way to interpret VAT; in effect, it would be a new tax.

With this in mind, it would be prudent to ensure that VAT continues to be interpreted with substance prevailing over form (so, in line with the current European law-based approach). It should be noted that the government has been moving in this direction in relation to other taxes – see CTA 2009, s 455C regarding the new loan relationship counteraction rules.

But what does all this mean in the short term? HMRC is already overstretched and struggling to deal with its workload and it is inevitable that it will find it difficult to deal with significant change. Perhaps the easiest approach is indeed for the government to stick to the status quo retaining substance over form.

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