

## Fortress Europe: A parting of the ways and implications for tax

### Customs and VAT - free movement of goods

The European Single Market means that goods and services can move freely within the 28 Member States of the EU, without any customs controls. Absent a future trading relationship, the UK will be forced to trade with Europe under the World Trade Organisation (WTO) model, in the same way that the EU trades with countries like China and the US.

At present, the UK benefits from more than 50 free trade agreements by virtue of being in the EU. If access to these is lost following Brexit, this could result in: import VAT being chargeable; customs duties; export/import declarations; greater administration costs and potential delays at the border. In fact, the UK Chamber of Shipping has warned of 'catastrophe' looming at ports.

The UK expects to enter some form of free trade agreement with the EU. However, free trade agreements do not literally allow 'free trade', but rather preferential rates for the movement of goods, under certain conditions.

Post-Brexit there could be issues with the distribution of products where the UK is used as a distribution hub. Customs or bonded warehouses may become more popular to keep goods in duty suspension before shipping them onwards into Europe. Questions also remain as to whether a UK entity can continue to act as an importer of record after Brexit, whether additional customs duties may be imposed on the distribution of goods and whether the customs value of products might be higher post-Brexit.

### Corporate tax

The UK has indicated that post-Brexit, it does not want to be bound by the European Court of Justice. If the UK is no longer subject to state aid rules, or if the UK loses the benefit of any of the key EU tax directives such as the Parent-Subsidiary Directive, the Interest and Royalties Directive or the Merger Directive, this would be significant.

Such changes could lead to increased withholding tax costs, and will force the UK to rely on its network of double tax agreements. There is particular concern about the 5% dividend withholding tax that would apply to dividends from German to UK companies and HMRC has indicated that one of its top priorities will be the urgent renegotiation of this treaty.

### State aid

Article 107 of the Treaty on the Functioning of the EU, which contains the general prohibition on State Aid, is a cornerstone of the Single Market. The state aid rules have increasingly been used by the Commission in recent years to crack down on certain harmful tax practices, which cannot be challenged on other grounds.

There have been three broad categories of state aid challenge relating to tax authority rulings: (i) that confirm transfer pricing arrangements -- where such arrangements may not be on arm's length terms; (ii) on profit allocation -- where the distribution of profits among group entities has not been done on arm's length terms; (iii) that facilitate hybrid mismatches -- for example, income that is not taxed in any jurisdiction.

The most important factor to consider in determining whether state aid has been conferred is whether a "selective advantage" has been granted.

In addition to rulings, tax settlements, tax amnesties, fixed base tax regimes and incentives could all be deemed to be state aid.

The Commission seems to want to develop a new arm's length principle for state aid, which will likely target, in particular, those Member States already on the Commission's radar for having issued tax rulings that are potentially open to state aid challenge.

### EU tax policy

The EU's approach to tax matters can broadly be divided into three phases:

**Phase 1:** historically, securing free movement and minimising the risks of double taxation.

**Phase 2:** more recently, ensuring a fairer tax system and further minimising the risk of double non-taxation, for example, through the changes to the Parent-Subsidiary Directive and the Anti-Tax Avoidance Directives.

**Phase 3:** moving forward, potentially encouraging greater harmonisation, which may see a reduction in tax competition across the EU, for example, through the CC(C)TB proposals for a common consolidated corporate tax base. However, these are struggling to make progress, with a number of Member State not in favour.

### Conclusion

There is significant uncertainty as to the potential shape of UK and EU tax policy. It remains to be seen whether the walls will go up around Europe to create a fortress of harmonised anti-avoidance rules, state aid challenges and high regulation, and what the UK's position is likely to be. Some have suggested that the UK could become a "Singapore of the West" -- that is, a low tax and low regulation haven on the edge of the fortress, but the recently agreed EU Brexit Guidelines show that the EU would try to prevent such a move in determining its future trading relationship with the UK.

