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The UK-EU Trade and Cooperation Agreement: Tax Implications

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Overview

On 24 December 2020, the UK and EU agreed a comprehensive Trade and Cooperation Agreement ("TCA") which sets out the basis for the future relationship between the UK and EU. The TCA was implemented into UK law by the European Union (Future Relationship) Act 2020 and took effect on 31 December 2020.

The TCA is a complex agreement spanning 1259 pages, but says very little about tax, although it does include a UK/EU commitment to uphold international tax standards, including on the exchange of tax information, anti-tax avoidance and public tax transparency. No doubt tax issues relevant to the future relationship between the UK and the EU will evolve over time; however, this article will summarise some of the key tax issues that arise from the TCA and from Brexit generally.

Direct taxes

UK direct taxes such as corporation tax, income tax and capital gains tax are not directly impacted by the TCA as these direct taxes have always been within the competence of the UK government. However, as a member of the EU, the UK had implemented a number of EU Directives that aimed to provide a common approach to certain tax matters concerning EU member states. Following the end of the implementation period, these EU Directives will no longer apply.

Of note is the Interest and Royalties Directive and the Parent-Subsidiary Directive. These EU Directives have previously been used by businesses to eliminate cross-border withholdings on payments between group companies. This means that from 11pm on 31 December, 2020, the tax treatment of payments of interest, royalty and dividend payments from the EU to the UK will depend on domestic law of the source country and the relevant tax treaty between that country and the UK. Although the UK has an extensive treaty network, and in many cases, this may eliminate any potential withholdings, procedures will need to be followed to claim treaty relief on a country specific basis. It should be noted that not all treaties between the UK and EU member states will eliminate withholdings, for example withholdings on dividend payments are permitted from Germany (5%).

Indirect taxes

VAT

Strictly, the UK will no longer be required to maintain a VAT system, although there are no plans for significant changes. VAT will continue to apply in its current form with potential for some specific changes in the future (e.g. zero or reduced rates), as the UK is no longer bound by the EU VAT Directive which mandates a minimum level of VAT on certain products. The UK government has already exercised its newly found freedom to determine the rate at which VAT is charged by removing the "tampon tax", which came into effect on 1 January 2021.

There will also be adjustments to the way the VAT system operates, for example the UK will no longer be part of the EU-wide VAT IT systems which means that access to the EU VAT refund system will cease and claims for VAT refunds from EU countries will need to be made using existing procedures for non-EU businesses, which vary across the EU member states. In addition, UK businesses making digital service sales to EU non-business consumers will no longer be able to report and account for VAT through a simplified EU procedure. Instead they will need to arrange a new registration with an EU member state to achieve this.

Customs

The UK will now operate a standalone customs regime, the UK Global Tariff, which will replace the EU's Common External Tariff. The UK's Global Tariff will apply to all goods imported into the UK unless certain exemptions are met such as, the UK having a trade agreement with the country that businesses are exporting to or importing from.

Under the TCA, there are no tariffs or quotas on any goods that "qualify". Qualifying requires meeting the percentage rules of origin thresholds set out in the TCA, which vary between goods. Detailed guidance on how business can understand and comply with the rules of origin requirements under the TCA can be found here. This means that, provided businesses meet the relevant rules of origin thresholds, they will not be liable to pay any tariffs when they export from or import to the UK from EU member states.

As the UK is now no longer a part of the EU Single Market and Customs Union, customs declarations for UK/EU trade will be required. Goods entering the UK from the EU will be phased in during the next six months to allow businesses to adjust to the changes of the TCA. This requirement to complete import formalities will be a significant change for UK businesses.

The TCA attempts to mitigate the impact of customs declarations and paperwork in various ways including providing for mutual recognition of "trusted trader" (Authorised Economic Operators (AEO)) schemes; this means that AEOs that have been assessed and recognised under either the UK or EU scheme will face fewer (but not no) controls.

Limitation on Benefits ("LOB") issues

The TCA may impact the eligibility of certain entities that have UK investors to claim relief under double tax treaties between the relevant jurisdiction in which that entity is based and the US. This is because many tax treaties with the US include a requirement that the non-US resident party satisfies a LOB test to qualify for benefits under the relevant tax treaty. To qualify, the party must meet one of several specified categories of person. A category sometimes relied upon is that the party is owned by EU residents. This may mean, for example, that group companies with UK parents that have previously relied on EU carve outs in US double tax treaties may need to rethink their group structures, as the UK has ceased to be an EU member state.

With the TCA now implemented into UK law, US inbound investors should consider the potential impact that the TCA has on their current and future transactions.

Potential for divergence and DAC6

The TCA contains commitments to specific tax standards as they stand at the end of the implementation period, including international standards on the exchange of information and anti-tax avoidance provisions. Apart from these specific tax standards, the UK has the scope to diverge from all other EU taxation standards, provided that the UK meets the OECD's minimum standards against Base Erosion and Profit Shifting.

One recent example of the UK diverging from EU tax standards is in relation to DAC6. The EU directive known as DAC 6 required the UK to introduce rules under which "intermediaries" are required to report cross-border transactions that concern the UK and/or an EU member state and bear a "hallmark" of tax avoidance. Unexpectedly, as part of the Brexit legislation enacted on 31 December 2020, the UK amended its rules introducing DAC6 to remove all but one of the hallmarks. The hallmark that is to be retained is hallmark D, which concerns arrangements intended to obscure beneficial ownership and/or undermine reporting obligations. Therefore, the scope of the DAC6 reporting obligations in the UK have been reduced considerably.

DAC6 implements the recommendations made in the OECD's Final Report on BEPS Action 12 (Mandatory Disclosure Rules); however, these recommendations had already been fully implemented in the UK before DAC6. The reason for retaining hallmark D is that this particular part of DAC6 reflects the EU's implementation of the OECD's Model Mandatory Disclosure Rules (MDR) for CRS Avoidance Arrangements and Opaque Offshore Structures. In order to meet OECD-agreed standards, the UK needs to implement rules addressing this part. It is intended that the UK will, in due course, replace this element with its own model disclosure rules that implement the MDR. It should then be possible to repeal the regulations implementing DAC6 in their entirety.

Conclusion

For present purposes, the most significant UK tax changes are changes to the way VAT, custom duties and withholding tax are applied, including in some cases payment of VAT at the border, loss of procedures which simplify VAT, and additional registrations or administrative procedures. Therefore, UK businesses which export from or import to the UK should pay particular attention to these new systems and rules as these changes are likely to disrupt the way in which businesses operate in the short-term. Also, group companies which rely on EU Directives should also consider revisiting their legal structures to ensure they do not suffer significant tax liabilities as a result of the TCA.

Going forward, the TCA presents an opportunity for the UK to set its own taxation policy and implement UK legislation to effect its intended policy objectives. Although very little has changed since the implementation of the TCA into UK law, there is potential for future divergence from EU law. The way in which the UK and EU deal with any potential future divergences will be of interest, particularly considering the specific international tax standards which both parties have agreed to and the importance that the level playing field commitments played in the Brexit negotiations.

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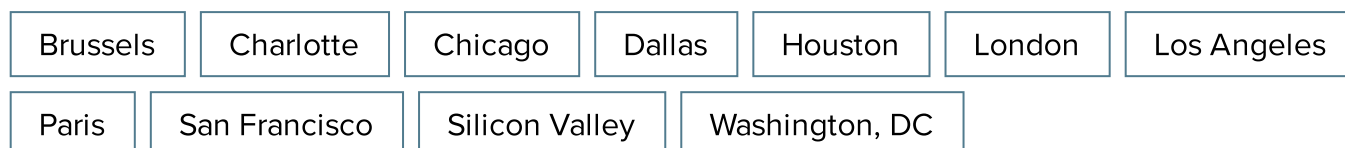

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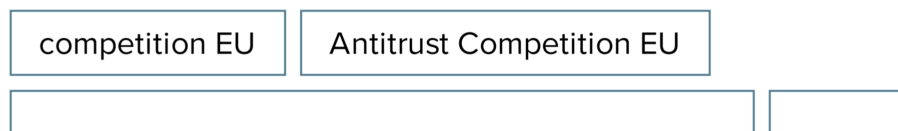

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