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Brexit: tax competition between the UK and the EU27

Since the outcome of the Brexit referendum there has been speculation about whether any UK/EU trade agreement would allow the UK to position itself as a tax haven. The UK/EU Trade and Cooperation Agreement imposes a number of restrictions on the UK, including subsidy controls and commitments to maintain certain OECD tax standards. Outside of these restrictions, opportunities remain for the UK to make its tax regime more competitive as compared to its EU27 neighbours, but it seems likely that divergences between the tax regimes of these jurisdictions will in any event develop over time.

Throughout the various stages of the Brexit negotiations, there has been speculation about what the final terms of any trade agreement would say about tax; in particular, whether the deal might allow the UK to position itself as the media-dubbed 'Singapore-on-Thames'. The broad idea being that the UK could set itself up as a tax haven boldly neighbouring the EU27 jurisdictions by aggressively reducing its corporate tax rate, offering targeted tax incentives to attract businesses to the UK and diluting rules countering tax avoidance. The question is whether the Brexit trade deal, as agreed at the eleventh hour, allows for this.

The 'Singapore-on-Thames' concept can be traced back to comments made by the then Chancellor of the Exchequer, Philip Hammond, in January 2017, that in the event of a no-deal Brexit the UK would be forced to change its economic model to remain competitive. Boris Johnson, in his capacity as both foreign secretary and subsequently prime minister, fanned the flames of this idea with comments about seizing the opportunity of Brexit to reform the UK's tax system and simplify regulation.

The UK/EU Trade and Cooperation Agreement (the ***TCA***) includes a number of tax-related provisions, but what type of limitations on setting tax policy do they impose? And perhaps more importantly, what does the TCA not address? We consider these questions below and highlight areas of divergence which, to a greater or lesser extent, could ultimately result in tax competition as between the UK and the EU27.

What does the TCA say?

Subsidy control

The bulk of the provisions in the TCA that are relevant to corporate tax are under the heading of 'level playing field for open and fair competition' (Title XI, Heading One of Part Two). Apparently this was one of the most difficult areas of the Brexit negotiations, particularly in relation to competition policy and the approach to state aid with the EU seemingly concerned that the UK could seek to undercut European businesses by providing greater subsides and/or tax incentives to British industry alongside a more relaxed competition regime.

The TCA provisions include the new 'subsidy controls' (essentially the UK's new state aid regime). The conditions for identifying subsidies in this regard are aligned with the equivalent EU rules and include express provisions identifying when tax measures will be considered 'specific' so as to satisfy one of these conditions. This is perhaps an unsurprising inclusion in view of the various ongoing EU fiscal state aid challenges.

It seems clear from these provisions that the UK is not suddenly now able to offer a raft of targeted tax incentives in order to attract businesses to the UK as per the Singapore-on-Thames proposition. However, while the criteria for engaging the subsidy control provisions are aligned with the EU equivalent rules, the interpretation and application of these rules will be overseen by a UK regulatory body (possibly the Competition and Markets Authority) meaning that it seems likely there will be at least some degree of divergence over time in the way the UK and the EU apply these rules.

Taxation standards and good governance

The TCA level playing field provisions also include the 'Taxation standards' provisions (in Chapter 5) which include commitments by the UK and the EU to maintain the level of protection in domestic legislation in relation to tax transparency and certain OECD BEPS Actions to at least the level of the OECD mandated standards as they stand at the end of the transition period. The key here is that in each instance it is the OECD rather than the EU understanding of these rules that the UK has committed to maintain (with an express exception to this approach only for public country-by-country reporting by credit institutions and investment firms).

The UK's approach in this regard has already been clearly demonstrated by the UK's (somewhat surprise) decision to limit domestic implementation of the EU tax disclosure rules (or 'DAC 6') to only what the UK views is required under the OECD's mandatory disclosure rules. By taking this approach, the UK has clearly demonstrated from the outset of the new UK/EU relationship its intention to transition to the international, rather than EU, approach on tax standards.

The specific OECD BEPS Actions identified in the Taxation standards provisions are the rules relating to corporate interest restrictions, controlled foreign companies (***CFCs***) and anti-hybrid mismatches. The UK had already implemented its version of these rules before the EU's implementation via the Anti-Tax Avoidance Directive (***ATAD***) (as amended by ATAD II). It seems possible, if it would want to, that the UK could now undo changes to these rules required by ATAD where the UK takes the view these go beyond what is required by the OECD standards (including changes to the UK CFC and anti-hybrid mismatches rules included in Finance Act 2019).

Chapter 5 also includes a tax good governance provision which includes a commitment to implement the minimum standards required by the OECD BEPS project. This further includes what the European Commission's EU/UK task force has described as legally binding commitments requiring the UK and the EU to apply principles of good tax governance, although it is less clear what standard the EU would hold the UK to in this regard.

What recourse would the EU have if the UK did move towards the more extreme version of the 'Singapore-on-Thames' model, including by, for example, fully repealing its tax disclosure rules along with its corporate interest restriction, CFCs and anti-hybrid mismatches regimes? Neither the disputes settlements provisions in Part 6 of the TCA nor the consultation and rebalancing provisions in Chapter 9 of the level playing field section apply to the taxation standards and good governance provisions discussed above. Most likely it seems that the UK's breach of these commitments would be subject to review by the governance structure provided for in the TCA and would perhaps be serious enough to be referred to the Partnership Council which heads up this structure. If the UK persisted with the breach it could be included as part of the five year review of the TCA (as per article FINPROV.3) or, more dramatically, the EU could threaten to invoke article OTH.10 which allows the parties to terminate Part 2 of the TCA on nine months' notice.

The EU might consider actions outside of the TCA; the UK could plausibly be added to the EU blacklist of non-cooperative jurisdictions. The EU is showing willing to use this tool more widely with the European Parliament recently voting in favour of a proposed new rule whereby territories with 0% tax regimes are automatically added to the EU blacklist. This would result in several British overseas territories being added to the list. The final decision whether to adopt this rules rests with the EU Council, now of course which does not include UK representation.

However, it seems very unlikely at this stage that the UK would want to risk triggering such responses from the EU having only just managed to secure the trade agreement before the end of the transition period with a number of key issues still outstanding, including access to EU markets for financial services.

Joint political declaration on countering harmful tax regimes

The TCA is accompanied by a Joint political declaration on countering harmful tax regimes. This sets out principles to be taken into account when assessing if a business tax regime is harmful and reaffirms the commitment of both the UK and the EU to apply such principles. It is understood that the EU's aim of this political declaration was to replicate the EU code of conduct on business taxation. This is not currently binding on EU member states which would seem to explain the rationale for including this as a less onerous commitment in a political declaration separate to the TCA. Nonetheless, it is expected this will be sufficient to ensure the UK does not undo BEPS related changes made to its patent box regime in a bid to attract IP heavy businesses to the UK.

What the TCA does not say

No obligation for the UK to adopt future EU proposals

Importantly, the TCA does not require the UK adopt future EU tax proposals. Anything otherwise would have gone completely against the UK government's post-Brexit vision. Tax measures are currently high on the EU's agenda, with various tax initiatives currently tabled. This includes the 'DAC 7' measures (i.e. reporting and exchange of information for digital platforms), proposals for general public country by country reporting (***CbCR***), proposed changes to the Energy Taxation Directive and, most recently, a consultation on the possible design of an EU digital levy.

A number of these measures are accompanied by OECD equivalents, such as the OECD model rules for reporting for digital platforms and CbCR is a minimum standard stemming from Action 13 of the OECD's BEPS project. However, in both cases the EU version of implementation goes further than that required by the OECD. The Action 13 report does not require public CbCR, that is an EU proposal. Similarly, the EU version of the reporting rules for digital platforms goes further than the OECD version, particularly as regards overall scope of these rules (as discussed by our colleagues in further detail here).

A key point is that, going forward, the UK is not obliged to implement the 'gold-plated' EU versions of OECD global tax rules. As already demonstrated with the UK's approach to DAC 6, the UK is able to implement its own version of these global tax rules (assuming the UK continues to implement these rules – see further below). Over time this will lead to a natural divergence in the tax rules between the UK and the EU27 and that divergence could ultimately lead to tax competition.

By way of example, if the EU public CbCR proposal is agreed (which at the time of writing looks increasingly likely) and the EU27 are thereby obliged to implement such rules and the UK is not so obliged and does not introduce such rules (despite the existing regulation making power it has to do so in Finance Act 2016 Sch 19 para 17), this could feasibly be the deciding factor for some corporate groups in whether to base their headquarters in the UK or the EU27. If this is the case for more and more EU tax initiatives over time, the UK has the potential to become more appealing for businesses through an organic divergence of tax regimes.

It is worth considering at this stage how the outcome of the OECD Pillars One and Two proposals could impact this landscape. If the OECD manages to reach consensus agreement by the middle of 2021, it seems likely that both the UK and the EU would take steps to implement the proposals. However, while these rules are premised on co-ordinated global implementation, experience tells us that in practice there will be differences in implementation, and again there will be divergence between these tax regimes, resulting, to some extent at least, in a degree of tax competition.

If the OECD does not reach consensus agreement by mid-2021, the EU has made it clear it will take forward its own proposals in relation to the taxation of the digital economy and, as mentioned above, has already taken steps in this regard by issuing a consultation on the design of an EU digital levy. Assuming the EU proceeds with implementation of such levy, the future divergences between the tax regimes of the UK and the EU27 in this area are likely to be more profound. It is not impossible that an EU digital levy could be introduced while the UK repeals its digital services tax in order to both smooth trading relations with the US and increase tax competitiveness as against the EU27. It will be interesting to see how this develops.

No restrictions on the UK corporate tax rate

The TCA does not place any restrictions on the UK's corporation tax rate. It has been suggested in the press that this has opened the door to the possibility of a low-tax UK environment post-Brexit and the start of a 'race to the bottom' in terms of corporate tax rates in Europe. The basic fact is that the UK was free to set its corporate tax rate (and income tax rates) before it left the EU; leaving the EU has not granted the UK any further freedom in this regard.

There are no signs at the moment that the UK government intends to drastically lower the UK corporation tax rate. In fact, one of the first things the current government did was cancel a planned further reduction in the corporation tax rate from 19% to 17%. Indeed, it seems more likely that the rate may increase (at least in the short to medium term) as the UK Chancellor considers possible tax revenue raising options to start to plug the eye-watering deficit in the UK's public finances as a result of the various COVID-19 support measures. This seems to be one of the few revenue raising options open to the Chancellor given the manifesto pledges not to increase income tax, VAT or NICs.

VAT

The UK has now officially left the EU VAT system and the TCA does not place any obligations on the UK to continue to conform with the provisions of the Principal VAT Directive (the ***PVD***) or future decisions of the ECJ considering the PVD, meaning the UK remains free to make changes to its domestic VAT legislation, including retained EU law. Consequently, while the UK VAT regime will initially broadly mirror the EU VAT system, it is expected to diverge over time which will allow for tax competition between the UK and the EU27. The UK has shown it is willing from the outset to diverge from the EU VAT rules with the recent change to zero-rate supplies of women's sanitary products.

The UK is now able to make changes to some of the fundamental building blocks of the EU VAT regime that were previously prohibited by the PVD. This includes the potential to set the standard rate of VAT below 15% and/or lower the reduced rate below 5% (the minimum rates dictated in articles 97 and 99 of the PVD). The UK could also expand the range of supplies subject to the reduced rate of VAT beyond those set out in the PVD. Even so, this currently seems an unlikely course for the UK to take when VAT receipts are already significantly reduced as a consequence of the impact of the COVID-19 pandemic and the UK is currently seeking ways to increase rather than decrease tax revenues.

One of the main changes to the UK VAT regime is that the UK will now treat imports/exports of goods/services with the EU in the same way as imports/exports with non-EU countries. A consequence of this is that the VAT treatment previously only available to 'specified supplies' made to non-EU recipients has been extended to EU recipients. This treatment allows suppliers to deduct input VAT incurred to make what would be onwards exempt supplies of financial and insurance services if made in the UK. This means for example that UK banks and other financial institutions making such supplies to EU recipients will have a better VAT recovery position than similar entities making intra-EU supplies. Irrecoverable VAT is a significant cost for financial institutions who may well think about how to make use of this new VAT recovery opportunity.

Withholding taxes

As was anticipated, the TCA does not preserve the application of various business friendly EU Directives, including the Parent-Subsidiary Directive, the Interest and Royalties Directive and the Mergers Directive, in the UK. New withholding tax charges on certain EU to UK payments of dividends, interest and royalties will arise as a result. While the UK's network of double tax treaties will eliminate or reduce most of these withholding taxes, there will now be withholding situations that would not have previously arisen. These gaps in tax relief may be addressed over time via renegotiation of double tax treaties and/or the EU27 implementing domestic measures to reinstate the pre-Brexit position. However, the EU27 may nonetheless have an ongoing competitive edge over the UK in this regard on the basis it is more straightforward to claim such relief under EU Directives than via double tax treaty claims.

UK's role in delivering international tax reform

The UK has prided itself on being an early implementer of international tax reform, including the OECD BEPS project minimum standards and recommendations. The UK was heavily involved in the OECD BEPS project, including providing input on discussions on the various Actions. In fact, the UK's anti-arbitrage rules provided some inspiration for the OECD's recommendations on Action 2 (neutralising the effects of hybrid mismatch arrangements) which were implemented on an EU-wide basis via ATAD. There remains opportunity for the UK to play a part in further global tax reform as part of the ongoing OECD Pillars One and Two projects (and any further OECD global tax projects). Somewhat ironically, this may mean that the

UK will continue to have an indirect influence on the EU tax regime despite no longer being a member state.

That said, one way the UK could increase its tax competitiveness is to cease to implement OECD global tax standards agreed post-31 December 2020. This would not be in breach of the TCA and the UK can no longer be forced to apply these rules via EU implementation. Whilst this is a possibility, it seems very unlikely, particularly given the statements in the UK's summary of the TCA highlighting the UK's leading role in developing and implementing global standards on tax transparency and fighting tax avoidance through the G20 and the OECD. The UK Chancellor also restated the UK's interest in the OECD Pillars One and Two project at a recent OECD/G20 Inclusive Framework meeting.

Concluding thoughts

Does the Brexit deal pave the way for a low-tax and less regulated UK tax environment? It is inescapable that the TCA imposes a number of restrictions on the UK in this regard, in particular, the subsidy controls and commitments to maintain certain OECD BEPS standards. This means the UK would be breaching the terms of the TCA if it sought to move to a type of tax haven status by repealing its tax disclosure rules and regimes such as the CFC and anti-hybrid mismatches rules.

Even so, outside of these restrictions, the UK can seek to make its tax regime more competitive as compared to its EU27 neighbours. In this vein, the UK could significantly reduce its corporation tax and VAT rates, but it would take a brave Chancellor who decides that slashing these tax rates in a bid to attract businesses is the solution to the UK's current very significant deficit in public finances. But a reduction in these UK tax rates remains an option in the longer term.

The current review of the UK funds regime may give an indication of the new types of tax competition the UK government is considering in order to make the UK more attractive to businesses whilst also adhering to the terms of the TCA. The recently published funds regime review makes clear that one of its aims is to identify options, including tax reforms, that will make the UK a more attractive location to set up, manage and administer funds. A related consultation includes proposals to create a highly competitive tax environment for asset holding companies in the UK.

So while it is very unlikely that the UK will move towards the more extreme version of the 'Singapore-on-Thames' model now it has left the EU, there is still potential for areas of tax competition between the UK and the EU27. There is scope for the UK to position itself competitively through deliberate tax policy measures, but also it seems likely that divergences between the tax regimes of the UK and the EU27 will in any event develop over time.

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