Analysis

Brexit: don't panic (yet)

Speed read

The UK leaves the EU on 31 January 2020. Whilst there are some tax and export changes, there are no trade changes. It enters an 11 month transition phase, during which it will remain inside the EU trade structures, namely the EU VAT regime, the customs union and the single market. The UK and EU must negotiate a free trade agreement (FTA) by December to avoid harmful no-trade deal WTO rules. Negotiations start in February, giving insufficient time for a comprehensive FTA. Instead, expect a deal around no-tariffs and regulatory alignment. The UK obsession to strike simultaneously a US FTA will complicate this.

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What happens for businesses on the 31 January 2020 when the UK leaves the EU? Not much. For a bit.

It is only when the UK leaves the EU trading structures – the EU VAT regime, customs union and single market – at 11pm on 31 December 2020 that real change happens. Up until that point, trade talks will resolve how much free access UK businesses will continue to enjoy in the EU. This will be played off against the limited amount of alignment and rule taking the UK will accept. At stake is £648bn in annual trade.

How will this play out over 2020? There will be some limited tax and trade changes on 31 January. How will the talks process unfold, and what are the flashpoints to look out for? The UK's desire to negotiate a parallel US trade deal will add to the confusion and hazards. But ignore the UK hubris on 'non-alignment'; the EU's global weight is perhaps too strong for much divergence. Given the short negotiating deadline, what is the minimum deal the UK should aim for? Is there now the risk of a new no-trade deal Brexit cliff edge on 31 December? And, lastly, what planning should businesses be doing now for the December EU trading structures exit?

1 February: no trade changes and no voice

Once the UK and EU Parliaments complete the ratifications of the new Brexit Withdrawal Agreement, the UK legally exits the EU on the 31 January. It will no longer be a member of the union; instead it will be a 'third country'. This includes leaving the political structures of the EU: the Council, Parliament, Commission and the CJEU.

The UK then enters the 11 month 'transition phase' until 31 December 2020. It remains part of the EU trading structures, namely the EU VAT regime, tax directives (such as Anti-Tax Avoidance directive), the customs union and the single market and other EU programmes. It is also still bound by the free movement of people. During this time, the UK will continue to be subject to EU directives, and it must continue to incorporate new EU rules into UK legislation. This means, as today, goods and services may continue to flow without tariffs, checks or regulatory restrictions.

The UK is, in effect, a non-voting member of the EU until the end of this year. The UK is already close to this status since it has been absenting itself, or joining unanimous votes of the other member states, on EU decisions for over a year now.

January 2020: transition period tax & export change risks

There are a small number of changes to tax and trade from 31 January 2020 that businesses should be alert to.

- **Tax directives:** All of the EU tax directives remain in place for the UK during the transition period. This includes the VAT and Anti-Tax Avoidance Directives. On the latter, there will be a problem where a state's domestic legislation has not fully incorporated the terms of the directive – and only makes a reference to the directive applying to EU companies. Since the UK is a third country after January, it could lose benefits afforded in the directive in this circumstance. This could hinder tax consolidations and groupings for EU companies with UK subsidiaries.
- **US double taxation treaties:** Some US/EU tax treaties refer to 'member states' only being able to qualify for double taxation relief. Again, the UK is excluded from this definition in the transition period. This could raise tax bills. Multinationals with EU/US entities should check if treaty provisions have been relied upon.
- **UK export rollovers:** Trade between the UK and EU will not alter in the transition period. However, it is less simple for UK trade with other third countries. Trade with countries such as the US and China, where no EU free trade agreement (FTA) is in place, will be unaffected. Where there are EU deals in place, imports into the UK will remain on the same terms. The UK must treat imports on the same terms (tariffs, quotas, regulatory recognition, etc.). However, those countries are under no obligation to 'rollover' the EU negotiated terms to UK imports in the transition. So far, the UK has signed 20 rollover deals for the 40 deals (covering 70 countries) the EU has. South Korea and Switzerland have agreed UK import roll overs, but Canada and Japan have not. UK exporters to these states must be aware of potential new or higher tariffs and quota restrictions if the remaining countries hold out on their rollovers.

February 2020 onwards: the future relationship

In February, attention moves from the binding Withdrawal Agreement (exit payment, citizens' rights, Northern Ireland, etc.) to the other document agreed last October, the Political Declaration. Since this document is non-binding, it did not get the intense scrutiny of the Withdrawal Agreement. It covers the future relationship, and to what degree trade terms will continue as today. This will be concluded in a FTA), which must be signed by the end of the transition period to prevent UK/EU trade flipping to the complex and high tariff rates of the World Trade Organisation.

What is settled is that a full customs regime will come into play at the UK and EU borders for trade. That means customs declarations and potential tariffs for the first time, in addition to the imposition of import VAT and more compliance.

The tension here will be around the UK's continued free access to the EU markets versus its ongoing alignment with EU single market rules – and not just today's rules ('non-regression'), but also the EU's future regulations ('dynamic alignment'). The UK will resist this since it ties its hands on FTAs with other countries, including the US and China.

However, despite all of the bluster in the media about the UK not accepting EU rules, we can expect limited divergence in practice. EU standards are recognised around the world,

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and whatever terms the UK seeks in negotiations, they will end up looking very similar to today's.

Getting a simultaneous US deal adds to the disorder

What will complicate negotiations, in addition to the short timeline, is the preoccupation by the UK of signing a US deal at the same time. The government wants to show it is not beholden to the EU. The UK and US will have different focuses, too: services for the UK versus goods and agriculture for the US. This will clog up the discussions.

This dual negotiation will perplex US and EU negotiators, since they will not wish to cement any terms until they see what the other side gets out of the UK. But the UK must focus on its EU FTA. The EU is the UK's most important market, and industries like pharma, car manufacturing and food are built around the existing frictionless flow of goods.

How negotiations for a UK/EU FTA will progress: key flashpoints

Both sides are now setting up negotiating teams. The teams come from trade departments, although the UK's team will be highly political and staffed from Number 10. The first important meetings start before the end of January. The two sides will set their negotiating mandates, which will include ambitions and limits for both teams, with clear stipulations about what they may negotiate on.

The EU will issue its mandate, signed off by the 27 member states by 25 February. It will assume a close future alignment with the UK, as agreed in the Theresa May Withdrawal Agreement in November 2018. However, the UK has since pushed this into the non-binding Political Declaration and won't accept it. This is where the friction will start. The EU will threaten to withdraw its offer of tariff-free imports from the UK if there is no agreement.

A series of monthly rounds of negotiations with the EU will then take place, broken up into industry and other specialisms. They will work towards creating 'chapters' of the FTA, and there will be well over 50 of these. At the same time, US negotiation chapters will be confirmed with the UK by late February. This is where the conflict between a US and EU parallel negotiating track will crystallise. The EU may start dragging its feet, as it will want to see the US deal first.

In the spring, draft chapter text will be presented by one side – or sometimes both – to start the negotiations. The two sides will then haggle over compromises, escalating these for approval on contentious issues. Between rounds, all interested parties outside of the negotiations have to be consulted with and cleared to ensure some agreement on the final outcome. At this point, watch out for fish! In the Political Agreement, this is hardwired as one of the issues that must be resolved early on, or there will be no deal.

After the chapter negotiations are concluded (possibly by September), the contentious issues will be worked on. This is where both sides' red lines have to be addressed. Market access against regulatory alignment is the major difficulty, as the EU will protect its markets from a cavaliering UK low-cost competitor.

Once political agreement is reached, both the UK and EU parliaments must approve any FTA in time for the 31 December transition period end.

What minimum FTA should the UK aim for?

Given that the self-imposed short deadline of December means a full FTA to replace existing trade terms will not be achievable, both sides should focus on some minimum goals. From 2021 onwards, single industry market access deals alongside the FTA may then be a more practical route, given the political urge to announce that 'a deal' (no matter how wafer thin and inadequate) is done.

These are the key requirements to minimise disruption:

- Whilst a full third-party customs regime will be applied on UK goods entering the UK, and vice versa after 2020, tariff elimination should be a starting and finishing ambition. If they waver from this goal, with line by line negotiations, then the deal will take years. Challenges will include the UK wanting to protect some sectors such as agriculture.
- Minimised border checks and paperwork to prevent trade friction via mutual recognition agreements, standards and assessment bodies.
- A basic Canada-style services deal. The risk for the UK is that if it does not gain much ground on services, where its major interests are, it will have lost its negotiating powers.
- Mutual recognition of professional and trade qualifications.
- Creation of a regulatory legislative communications forum to avoid any unnecessary divergence and therefore trade barriers. This could be supported by an overarching governance framework. If the UK fails to give any commitments on regulatory alignment (vs independence), a meaningful deal may not happen.
- On the 'level playing field' rules around basic labour, taxation, state aid or environmental standards, a 'non-regression' clause is required from the UK to ensure it does not reverse existing commitments in these areas. This had been agreed to in Theresa May's version of the Withdrawal Agreement. It would be desirable, but perhaps unachievable, for UK industry to have a future 'dynamic alignment' clause to maintain. Without a robust level playing field provision, the EU will not drop its tariffs on UK exports.
- Agreed retaliatory measures for both sides to deploy in the event of unacceptable actions by the other side. The EU is planning something similar with Switzerland.
- Industry-specific access agreements on energy, aviation, security and defence.
- Migration and movement of people agreements, including business VISA waivers.

Mind the services gap

The loser will undoubtably be services, which accounts for 80% of the UK economy, and 40% of EU trade. With the UK heading for a 'quick and dirty' goods and tariffs deal, services will be ignored. The main reason is the UK's unwillingness to accept free movement of people, which the EU binds to services deals. Financial services are clearly hugely at risk with the loss of 'passporting' rights, which enable the retail sale of products to the EU from the UK, but the banking, payments and insurance sectors have already restructured for this.

Where the UK could be hurt is on mixed goods and services contracts. Most complex engineering goods come with highly lucrative service elements. There could be heavy restrictions on these, since using the UK as the service base will become challenging.

The tax and regulatory enclave of Northern Ireland

The key that unlocked the Brexit withdrawal deal last October was solving the Northern Ireland no-border problem. This was done in the Northern Ireland Protocol, within the Withdrawal Agreement, by moving any customs border to the Irish Sea, and creating a dual UK/EU status for Northern Ireland. Northern Ireland will remain inside the UK trading and tax systems, but simultaneously would apply the EU VAT, customs

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union and single markets rules. These will be administered by HMRC and other parts of the UK government. EU VAT and customs tariffs on goods moving from Great Britain to Northern Ireland and then onto Ireland would be collected by HMRC. Customs and single market checks would be carried out by UK border staff, under the watch of the EU.

There remain several unanswered questions on this arrangement to be resolved in 2020:

- Since Northern Ireland has a trade deal with the EU, in the event of a UK no-deal Brexit in December 2020, Northern Irish businesses would remain under the EU rules. This would mean that trade between Northern Ireland and Great Britain would be very complex. What would be the position for businesses which operate in both jurisdictions?
- How will goods be tracked to determine if UK or EU tariffs and VAT should be applied, since the final destination is not always known? One of three potential bases could be applied: by product type; by company; or by tariff code.
- What is the capacity of HMRC to administer a second VAT and customs regime in Northern Ireland?
- What documents must be prepared for goods moving between Northern Ireland and the rest of the UK?
- Will UK companies within Northern Ireland remain under EU regulations?
- What EU checks on goods will HMRC have to perform on goods moving between the EU and the rest of the UK?

Don't rely on an extension

Within the Withholding Agreement, there is provision for an extension of the transition period and for the UK to remain in the EU trading structures. This could be extended until 2022. The UK must request this by 1 July 2020. The business community will lobby hard for this. Their argument will be that any FTA terms will only become clear around November 2020. Businesses will plead that they then need at least two years to pivot to the new non-aligned regimes.

However, the UK government's 'get Brexit done' mantra and its desire to end the UK financial contributions to the EU budget mean that an extension would not survive the political optics test. Even if becomes clear to both sides it will be required, there is not the flexibility of the article 50 phase for an extension.

Achtung: no-deal Brexit

The UK has now avoided the risk of a 'no-deal' Brexit following the general election, greenlighting the passage of the revised Withdrawal Bill. However, this has now created a new cliff edge: the risk of no FTA being concluded by 31 December. This would result in the UK moving to WTO terms. That would mean the full imposition of EU tariffs on UK goods, and loss of any free access (regulatory approval and recognition) to the single market for goods and services.

2021: get ready for now despite unanswered questions

Given what is known about the next 11 months, what should businesses be doing?

Firstly, confirm with customers, suppliers and staff that there will be no material changes on 31 January. Whilst businesses now know the UK will be out of the trading structures of the EU come 31 December 2020, and should plan accordingly, many important questions remain unanswered:

- Is the postponed accounting (import VAT deferment account) to be offered again? This would relieve importers of EU goods into the UK of import VAT which becomes payable after December.
- How lenient will EU tax authorities be on UK businesses in terms of issues such as appointing a local VAT fiscal representative and submitting last VAT recovery claims after 2020?
- Will HMRC's transitional simplified procedures scheme still be on offer? This would enable deferment of customs declarations and tariff payments on UK imports.
- What are the Northern Ireland declarations requirements on goods arriving between it and the rest of the UK?
- The complex area of rules of origin must be clarified so UK businesses know if they can benefit from reduced tariffs between the UK and EU.

Nevertheless, there are measures that UK traders can start taking now, or at least planning for:

Customs and tariffs:

- Map out supply chains and where tariffs and import VAT will be payable. Ensure it is clear which party will be responsible as the importer of record.
- Build in-house customs declarations expertise, or hire a customs agent.
- Ensure businesses are signed up for transitional simplified procedures, and think about authorised economic operator status.

VAT:

- Ensure that accounting and enterprise resource planning systems are being reconfigured for the ending of intra-community zero-rated transactions.
- Check that businesses can avoid any import VAT cash payment through postponed accounting.
- Consider new EU VAT registrations to avoid the worst losses resulting from the loss of EU VAT simplifications.
- Ensure that businesses are registered for the new small parcel VAT declarations portal if they sell and import small packages.
- Apply for a MOSS registration if providing digital services.

Other operational issues:

- Verify that exports will still have EU regulatory certification, and what new applications will be required.
- Check if billing systems are able to support logistics, pricing and delivery terms changes.
- Review contracts with EU suppliers or customers to verify the post-Brexit implications.

Conclusion

The headline is that there is no immediate panic for UK businesses on 31 January 2020. Minor changes in tax and exports will leave most of the 240,000 UK businesses that trade with the EU untouched. However, there is now no excuse to start planning broadly for the end of the standstill transition phase, which ends on 31 December 2020, with the UK leaving the EU VAT regime, customs union and single market.

The next 11 months of negotiations between the UK, EU, US and others will be a daily drama of cliff edges and threats of no-deal Brexit that will make the previous three years seem like the easy bit. However, despite the bluster, it is likely that the UK will not end up as far from the EU rules as the UK government and media makes out today.

But get ready for a lot of customs and VAT paperwork and costs. ■

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- Tax and the Withdrawal Bill (Ashley Greenbank, 8.1.20)
- Revised Brexit deal: changes and risks (Richard Asquith, 22.10.19)
- A Brexit tax checklist: are you ready for 'no deal'? (Ashley Greenbank & Charishma Juddoo, 7.2.19)

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