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Dear Sir/Madam

Retained EU Law (Revocation and Reform) Bill: Raising Specific VAT Consequences

This response to the call for evidence on the Retained EU Law (Revocation and Reform) Bill focuses on the specific consequences arising from the Bill with regard to Value Added Tax ("VAT"). The response reflects the views of a working group within Ernst & Young LLP and is not intended as a comprehensive review of the Bill.

Within the European Union ("EU"), VAT is one of the most harmonised fields of taxation. Within the UK, the interpretation of the VAT rules is heavily reliant on EU law, with key definitions found only in EU law and UK case law taking its lead from the EU VAT directive. As such, VAT which, compared to other legal fields, has relied disproportionately on EU law before Exit Day, will inevitably be disproportionately impacted by the Bill. The risks are that the automatic sunset clause would lead to unforeseen and unintended consequences, and that there is insufficient time and resource available to ensure that these consequences can be addressed.

In the field of VAT, there are changes that could be made to improve the operation of the regimes (few would seek to defend the way that the complex zero rating for food operates and the sometimes bizarre border issues with it). However, we consider that these would be better considered on a case by case basis rather than by a wholesale removal of EU rules which are currently in effect, and which will lead to unpredictable outcomes and, inevitably, some unwelcome results.

Background

Before Brexit, VAT in the United Kingdom had, in accordance with Section 2(1) of the European Communities Act 1972, effectively been governed to a significant extent by two key instruments of EU law:

- Council Directive 2006/112/EC ("the VAT Directive"), which contains detailed rules on almost every aspect of VAT, covering inter alia the scope of VAT and exemptions, as well as rights and obligations of taxpayers.
- Council Implementing Regulation (EU) 282/2011 ("the VAT Implementing Regulations"), which provides for important definitions as well as simplification rules to make VAT operable (such as presumptions a taxpayer or the authorities are entitled to rely upon).

Currently, Sections 2 to 7 of the European Union (Withdrawal) Act 2018 have the effect that both aforementioned instruments of EU law as in force on Exit Day continue to be available and enforced in domestic law, hence ensuring continuity and leading to a situation where Exit Day did not result in an immediate material change of the legal status quo as far as VAT is concerned.

Consequences of the Abolition of the VAT Directive

In Clause 3, the Bill abolishes Section 4 of the EU(W)A 2018. In accordance with para 80 of the Explanatory Notes, we understand this provision to generally result in the sunset of the status of EU treaties and directives as retained EU law. Furthermore, Clause 4 abolishes the principle of supremacy. The combined effect of these provisions appears to be the effective termination of any legal effect derived from the VAT Directive, unless explicitly retained by Parliament or through one of the instruments envisaged in the Bill.

For VAT, the impact of this measure could be potentially significant, in particular since there is little precedent and guidance in case law on the effect of UK VAT legislation if one was to interpret it without regard to the VAT Directive. This is the result of a tendency within courts and tribunals to rely directly on the VAT Directive when considering VAT cases. The trend to refrain from a detailed interpretation of UK VAT legislation was succinctly summarised by Mummery LJ in *Commissioners v BAA plc* [2002] EWCA Civ 1814, at para 46:

> "What useful purpose is served by the draftsman in his own elaborate language setting out what he understands to be the effect of the Sixth Directive […]? At best it is unnecessary; at worst it constitutes a breach of the United Kingdom's obligations […]."

This means that, as far as VAT is concerned, there is an inherent tension between the Bill's intention to bring to an end the effect of the VAT Directive while seeking to retain case law which is based more or less exclusively on the interpretation of that directive.

We concede that the Bill recognises this issue in principle and therefore envisages referrals by lower courts and tribunals to higher courts for the purpose of reconsidering case law based on retained EU law. However, for VAT, the risk is that this would open almost every matter which has been decided by the courts in the last decade for re-litigation, given that the approach of reliance on the VAT Directive as set out by Mummery LJ in *BAA* (above) has been followed by courts and tribunals in an overwhelming majority of cases.

This risk is increased by the number of instances where the wording of the UK national legislation differs from the terms of the VAT Directive. There are two conflicting interpretations of what might happen in that event:

- One might argue that the interpretation in accordance with retained EU law, as in force before the end of 2023, should remain valid since Parliament must be presumed to have enacted pre-Brexit domestic legislation for the purpose of implementing EU law. In other words, Mummery LJ's approach in *BAA* remains valid and should be followed accordingly.
- Alternatively, it could be argued that such an interpretation is inconsistent with the current Bill as it goes against the explicit intention of the Bill to terminate the supremacy of EU law and, by implication, the effect of the VAT Directive.

We are concerned that the tension between these two approaches could give rise to significant uncertainty, and therefore cost to the UK economy, at a time of considerable economic difficulty.

The following example illustrates this issue further.

Under art 135(1)(d) of the VAT Directive, "debt negotiation" is explicitly excluded from the VAT exemption on financial services. The same exclusion is, however, neither explicit nor implicit in the wording of the UK's domestic implementation of that exemption in schedule 9, group 5, item 1 of the Value Added Tax Act 1994 ("VATA 1994").

In *Commissioners v AXA UK* [2011] EWCA Civ, 1607 Arden LJ (as she then was) found, at para 47, that the carve-out for debt collection nevertheless applies in the UK, but solely for the reason that item 1 must be presumed to implement the whole of art 135(1)(d) and therefore also the carve out, in spite of lacking respective wording.

If the Bill was enacted in its current form, it would not be clear whether debt collection would be excluded from the VAT exemption after 2023:

- In favour of answering in the affirmative, one might argue that Arden LJ's statement in the aforementioned judgment concerns nothing more than the interpretation of domestic law which cannot be affected by the Bill, given that the VATA 1994 was implemented at a time when the UK was still a member of the EU and therefore intended to fulfil the UK's obligations under the treaties.
- By contrast, one could argue that that interpretation was based on the supremacy of the Directive and therefore no longer has effect. As a consequence, in the absence of any explicit or implicit condition in item 1, one would reach the conclusion that debt collection can, in principle, be VAT exempt (subject to the service falling within the scope of item 1 in the first place).

What is likely is that this issue would fall to be litigated again, bringing further uncertainty to UK businesses. There are many such examples, not all of which are instantly identifiable but instead are likely to light in the years after the sunset, lead to uncertainty for businesses, and potentially impact tax revenues.

The issues outlined above arise only to the extent that no relevant body makes use of its statutory powers under the Bill to retain the current (EU-derived) legal status quo. Nevertheless, in our view, to the extent the legal status quo is not explicitly retained, a potentially large number of VAT issues resolved by the judiciary in the past decades, or understood by taxpayers and HMRC to be in line with the requirements of EU legislation but not fully reflected in UK legislation, could be re-opened for litigation.

Consequences if the VAT Implementing Regulations sunset

The VAT Implementing Regulations currently constitute "retained direct EU legislation" and have become domestic law by virtue of Section 3(1) of the EU(W)A 2018. Under Clause 1(1)(b) of the Bill, they would sunset by the end of 2023 (or mid-2026 the latest) unless retained by a Statutory Instrument envisaged under the Bill.

If the VAT Implementing Regulations were to sunset without replacement, uncertainty would arise with regard to crucial parts of the VAT law since a number of definitions would simply disappear from the legislative framework. Examples include definitions for "business establishments", "fixed establishments" or "electronically supplied services". In the absence of explicit definitions in the legislation, courts and tribunals would likely have to engage in an interpretation based on the general principles of English Law, while simultaneously being constrained by retained case law which would need to be reconsidered based on the procedures envisaged in the Bill. While it may be the case (but is in no way guaranteed) that that exercise would produce a similar understanding as currently codified in the VAT Implementing Regulations, a sunset of these regulations would potentially open important definitions in the operation of VAT for (re-)litigation.

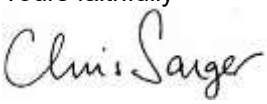
Conclusion

In our view, it is important to debate fully whether it is desirable for UK VAT to depart from the current (EU-derived) status quo (and any answer may find that it will be desirable in some cases but not others). However, we note that the Bill in its current form has the potential to create significant uncertainty in the operation of VAT through its extreme sunset mechanism. Our concern is that the Bill might result in considerable business uncertainty in the months after any sunset of the EU applied VAT rules and a notable increase in controversy and litigation between HMRC and taxpayers. It would be much more preferable for changes to the VAT legislation to result from due consideration by government and Parliament, and consultation with industry where appropriate. That would involve a different approach, whereby EU legislative interpretation remained in force until specifically amended for deliberate reasons.

We are particularly concerned that, regardless of what resources are given over to the project, it will not be possible in practice to identify before the end of 2023 all of the potential issues that could arise. We are further concerned that HMRC does not have the necessary resources at this time to commit to the project, and that to devote the resources required over such a short timetable would risk shortages elsewhere in the system.

If you have any questions on the above, please do not hesitate to contact Mitchell Moss (mmoss@uk.ey.com) or Fabian Barth (fabian.barth1@uk.ey.com).

Yours faithfully



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