European and External Relations Committee

The EU referendum and its implications for Scotland

Written submission from the Institute of Chartered Accountants of Scotland (ICAS)

1. Introduction

1.1. ICAS welcomes the opportunity to give evidence to the European and External Relations Committee regarding the inquiry into Scotland’s relationship with the EU.

1.2. The Institute of Chartered Accountants of Scotland (‘ICAS’) is the world’s oldest professional body of accountants and we represent over 21,000 members working across the UK and internationally. Our members work across the private and not for profit sectors.

1.3. The ICAS Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members’ views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which should be paramount.

1.4. ICAS has recently established a Brexit Advisory Group to consider the implications of Brexit in more detail. This is very much a work in progress and our positions will evolve over time. We have set out our initial observations below and we would welcome a continued dialogue on this topic. Our comments below are restricted to our areas of expertise and experience. We are not in a position to comment on the legal, constitutional or political aspects of this topic. Our comments are based on the UK’s existing constitutional arrangements, including devolved settlements.

2. Initial observations - key messages

2.1. We have considered the following areas:

1) Setting an objective and articulating the vision of Brexit
2) Communicating key principles underlying the approach to Brexit
3) Gathering quality information and an evidence based approach to managing Brexit
4) Identifying what will not change to maintain stability and certainty
5) Developing a roadmap for change for the longer term

2.2. We welcome the inclusive approach to engaging in the negotiations including the active participation of the Scottish government (and other parts of the UK) to help work out an agreement which best suits the needs of the whole of the UK and its constituent parts.

2.3. These are still very early days and without clarity as to what the UK Government is seeking to achieve, a vision of what Brexit will look like and what our relationship model with the EU will be, it is difficult for us
to comment meaningfully on the implications. Many of our areas of expertise which may be affected by Brexit have a UK wide relevance.

2.4. We support an inclusive and evidence based approach to managing the outcomes of Brexit. This is a complex topic and we would welcome the publication of further statistics and analysis from government on the form and scale of our relationship with the EU, at a jurisdiction, sector and policy level.

2.5. At this point in time, it is perhaps too early to focus on the detail. To pick and choose what parts of the complex European regulatory framework need amended is a vast undertaking and will take many years. Rather, the key priority at present is for the UK Government (assisted by the devolved administrations) to establish a clear vision of what Brexit means for the UK, the EU and internationally. This would provide assurance to stakeholders as to the intended direction of travel and hopefully help to manage some of the current uncertainty.

2.6. To accompany the vision, key objectives and principles setting out how the UK Government should go about exiting the EU would also help to manage uncertainty. Suggested principles for this purpose from an ICAS perspective are provided in our detailed comments in section 3.1.

2.7. We suggest that it would help for the UK Government to communicate a clear expectation of the areas which it believes it can/ cannot change and by when.

2.8. Stability and certainty are key to providing the basis for business to thrive are key. Our FD survey identified that freedom to hire talented individuals, minimising regulatory barriers and low tariffs are the top priorities for finance directors. We also note that access to the EU single market is a priority for financial services.

2.9. As part of mapping the transition process, we suggest that the first area of should be: what the UK does not intend to change, to maintain stability, certainty for business and facilitate planning. This includes:

- Regulatory stability and a commitment to international standards (where appropriate).
- A suitable, even generous transition period and an intention to only introduce a moderate level of significant change in sensitive areas until effective alternatives are demonstrated as providing a better solution.

2.10. The EU referendum result appears to have generated some surprise across business, investors and the international community. Articulating and communicating the strengths of both the UK and the devolved administrations i.e. why they each remain a good place to conduct business could help to shift focus in a positive and constructive direction.
2.11. Such reasons include: a trusted and reliable company law environment; a proportionate approach to regulation (the UK pioneered the principles versus rules approach); the presence of a leading and experienced global financial services industry accompanied by a track record in delivering success; one of the most competitive tax incentivised locations in the world to start a business; and a tradition of being at the forefront of corporate governance, innovation and research excellence etc. The UK has also demonstrated an ability to operate flexibly and quickly to react and meet market needs.

2.12. For the more advanced transitional stages, a roadmap setting out what the UK Government may seek to change could include:

- Identification of priority areas for impact assessments and an action plan. Examples include what to do about the single market (especially for financial services), supplier cross border tariffs and rules of origin to provide assurance to international businesses and investors.
- Maintaining engagement with the EU. To establish a deal whereby the UK and other countries with material interests or contributions in key pan-European issues such as the economy, security etc. have a forum and mechanism to contribute and influence.
- Modernisation of the EU given its continued importance and significance to the UK whether formally part of this or not, is still relevant.

2.13. A balanced assessment of the pros and cons of the UK’s experience as a member of the EU as a means to provide a firm rationale for change. This will involve being frank about some of the challenges of operating within the EU, where we aim to be different in approach and where we see opportunities to operate better than within the EC.

3. Initial observations - detailed comments

3.1 Our suggested principles underpinning an approach to Brexit include:

Openness, transparency and accountability

- An evidence based approach to policy development which includes regular update reports so that the public can see progress and understand why a prudent and steady approach is needed for certain topics
- A commitment to behaving with honesty and integrity; to communicate facts and a fair balanced and understandable assessment of the issues and implications arising from Brexit.
- An inclusive perspective which considers UK, EU and international needs (linked to ‘do no harm’)
- An inclusive approach to developing solutions which includes opportunities for relevant stakeholders to contribute and holistic approaches
• A proportionate approach to addressing policy needs (i.e. the solution itself is not greater than the problem)

• A commitment to the smart regulation agenda, principles not rules and an end-user/outcome based approach to maintain a business friendly environment

• Do no harm.

Management information

3.2 It is difficult to identify the total and type of European funding to particular groups of organisations e.g. SMEs, charities etc. and to break this down to jurisdiction levels. The information appears complex and fragmented. To support an evidence based approach, we would welcome a ‘heat map’ showing which areas, sectors and priorities are likely to be at most risk of funding withdrawals and how EC priorities compare with UK government priorities. This would also need to be supplemented with time profiles, projection trends and comparisons with domestic and international markets to give context.

3.3 High quality and publicly accessible information from government to inform decision making and the wider electorate is a priority. This would help to encourage wider informed debate and an evaluation of the varying impacts.

Stability and certainty

3.4 Stability and certainty for business to thrive are key. Businesses will naturally be cautious when considering investments today which need access to the EU to assist in making the required return. They may decide not to make them or just defer them, either way there is an impact today. This will similarly affect EU nationals working here (how we can keep/recruit the best people for the role), and may have specific impacts on higher education as EU nationals are put off from entering a three year course during which time Brexit will happen.

Cross sector issues

3.6 There are many on-going projects which receive EU funding. Whether there is potential for claw backs, exit costs or repayments on such projects needs to be determined and quantified to identify possible additional funding requirements. For public, private and third sector bodies which are currently in receipt of EU funds it would be helpful to clarify if there will be any transition arrangements or alternatives to maintain financial sustainability.

3.7 OJEU procurement rules are complex, this is incompatible with achieving greater effectiveness and we would welcome further simplification. Our members in business and practice reported that the public procurement process is overly prescriptive and burdensome. There are concerns that the organisation does not come out of the procurement process with a better result. It is slow and costly to
implement and as a result, disadvantages small suppliers who do not have the resource to absorb this. In addition, we would also highlight that grant procedures are arduous and too detailed. This approach is also viewed by charities as a barrier to competing effectively for public sector contracts.

3.8 In our view, the EC procurement thresholds are set too low, particularly for supplies and services which can range from as low as €80,000. There is minimal if any cost benefit to apply procurement rules at current levels, given their arduous administrative burden. Our preference is for the rules to be applied at a much higher threshold, at least €1m or even better, €5m. Secondly, tendering is based on the full life cycle rather than annual amounts – again this is too low a threshold and it brings in too many lower value projects. Our view is that it should be on the annual amount to avoid lower cost annual contracts being brought into the EC procurement rules.

3.9 **State aid** - it is very likely that some form of state aid provisions would remain in place post-Brexit, as it is required both by membership of the World Trade Organisation (WTO) and the European Free Trade Association (EFTA). Our preference would be for a model which is simpler to operate, less rules based and where a higher threshold is set for example, exempting at least the smaller end of SMEs who are likely to have a much more limited impact on competition.

3.14 The WTO rules present a number of practical problems, for example, there is no mechanism for advance notification and approval. Instead, business support which a country grants in good faith, in the belief that it won’t produce adverse trade effects, may fall foul of the restrictions retrospectively.

3.15 There is a desire to shift from crisis spending to preventative spend. This approach is designed to save money in the long-run but needs working capital to make a decisive shift. The UK and Scottish Government’s as debt financing provided to charities would likely be caught by the State Aid rules which provides a challenge for funding this shift to preventative spend. While it would be desirable to have a more flexible approach to State Aid rules which would allow such spending initiatives to be exempt from State Aid rules, there is no certainty this would be any more achievable using a non-EU model.

3.16 **Financial reporting** – currently requirements relate to IFRS as adopted by the EU. Following its exit, the UK would have the ability to specifically adopt IFRS standards as issued by the IASB without them firstly having to be adopted by the EU. International standards are the benchmark for consolidated accounts and it is considered highly unlikely that the UK would diverge from this framework for listed companies. It may however introduce its own endorsement mechanism.

3.17 The UK **corporate reporting** environment is generally viewed as highly-developed and often exceeds the minimum EU requirements;
therefore, it is unlikely that UK withdrawal from EU membership will lead to significant changes.

3.18 In terms of **audit**, the UK has only just introduced the 2014 EU Audit legislation and it has been incorporated into UK law on 16 June 2016. Although in theory, there may be scope to consider and review/revise aspects following Brexit, it is not certain if there would be much appetite to diverge significantly from the core principles.

3.19 **Environmental issues** - much of the environmental law in the UK has been taken directly from EU directives with each of the individual UK nations transposing the requirements into their national legislation. In some cases, this legislation goes beyond the EU requirements. Therefore, there is not likely to be any reduction in the UK’s, nor Scotland’s, environmental objectives and commitments as a result of Brexit.

3.20 The EU’s impact on **pensions** is UK relevant and largely on private rather than state or public service pensions. Key EU pensions directives are IORP I (2003) and IORP II (implementation due 2018). The former includes a requirement for defined benefit cross-border schemes to be fully funded. UK lobbying influenced the moderation of the wording to include a funding plan although full funding is still required. It is unclear whether or not the UK will adopt IORP II. However, as implementation of the Directive is due by late 2018 and the UK is still likely to a member of the EU at that time, implementation in the UK is a strong possibility. It is unlikely that the UK would make radical changes to pensions law and regulation in the short-term as a direct consequence of the UK withdrawing from the EU but it would certainly lose influence over the content of future IORP Directives.

3.21 Outside the EU, the UK would no longer be subject to these Directives, although membership of the EEA or EFTA or even a bespoke arrangement would likely come with conditions, so some IORP Directive requirements may remain in place.

3.22 To attract businesses, the UK also needs to offer stability and certainty in its tax system. It is a political decision as to whether a low corporation tax rate might encourage investment, or whether this may be viewed as unduly aggressive at a time when other developed nations are tackling base erosion and profit shifting responsibly through concerted actions flowing from the OECD’s BEPS project.

3.23 Even in cases where pre-existing corporate structures are thought likely to be sound for future tax purposes, other factors may influence the choice of business location. An example is ‘passporting’, which currently allows authorised financial services businesses to operate across the EU from a base in the UK; this won’t be possible after Brexit unless a special deal can be negotiated.
3.24 It is challenging for multinationals to plan for business after Brexit without knowing what precisely will emerge. It adds further complexity that the Brexit talks will be taking place at the same time as countries are making changes arising from BEPS, including the implementation of proposals to restrict treaty abuse.

3.25 As we are in a transition period, it helps if the government is clear on what principles it will apply when developing new policies. ICAS articulated principles of taxation in our response to the Scottish Government on local taxation. These are copied in Annex A.

3.26 The Brexit negotiations will need to cover the extent of the UK’s liability for the pensions of EU officials (i.e. civil servants) and others. The current estimate of the liability is €60bn.

3.27 The main areas of tax affected by Brexit include customs duties, VAT and direct taxes for international businesses. There are also fundamental tax questions for multinational businesses. One of these is the continuing suitability of the UK as a holding company location after its eventual departure from the EU.

3.28 For further information, please refer to: Brexit tax: Customs Duties and Brexit tax: The future of UK VAT. There are also fundamental tax questions for multinational businesses. One of these is the continuing suitability of the UK as a holding company location after its eventual departure from the EU – see Brexit tax: Holding companies.

3.29 The ending of the relationship with the EU may result in a number of tax powers being repatriated to the UK and potentially the devolved jurisdictions. ICAS has identified some principles to determine the decision basis for any devolution of new powers. We have also provided some comments on tax competition in Annex A.

**Sector observations**

3.30 The impact on **insolvency** is explained here: Brexit: Implications for insolvency and restructuring. It contains matters of UK and Scottish relevance given the legislative framework. In brief, UK insolvency proceedings would no longer benefit from automatic recognition across the EU (and vice versa). It is expected that limited opportunity for cross border European co-operation would add cost, complexity and uncertainty to insolvency and restructuring situations. Continued mutual recognition of proceedings is a priority, although achieving this involves a number of complications. We would highlight:

- The continued need for cross-border insolvency regimes and procedures to be recognised. This ensures that recovery of assets for the benefit of creditors can be carried out efficiently and quickly without having to open up separate proceedings in each legal jurisdiction.

---

1 EU’s consolidated annual accounts for 2015
- The continued need for court judgements to be recognised cross-border. (Similar objectives to above)

- The continued need for jurisdiction based on COMI (Centre of Main Interest) for restructuring schemes in the UK (such as Schemes of Arrangement) to be recognised

3.31 **Charities** – there are no issues which are uniquely Scottish in nature in relation to charities and Brexit which we have identified to date. In the UK, charity law and regulation are not driven by EU law, but charities, like other employers and service providers, charities are impacted by aspects of the EU and EU law. We would highlight the importance of this diverse sector to public life: supporting vulnerable beneficiaries; delivering public services; providing employment; and being agents of change.

3.32 One of the key risks is financial sustainability and although we believe continuity of grant funding will be the most significant, we have not been able to obtain figures to substantiate this. Figures are available on the use of Gift Aid\(^2\) which reports that UK charities received €3.4 million in donations from donors based in other EEA states. Although, the overall sums involved are not significant in the overall context of Brexit they could be significant for individual charities. It is not possible to breakdown these figures further to show how much was donated by Scottish taxpayers or received by Scottish charities.

3.33 The future of these arrangements will depend on the outcome of the Brexit negotiations and the UK’s future relationship with the EU and EEA.

3.10 In Scotland, with the evolving landscape in relation to **public finances**, transparency and accountability are key. The devolution of powers, abilities to raise taxes, new borrowing and increasing responsibilities that come with those powers, means that information requirements to maintain effective accountability have increased. It is therefore appropriate and timely to review the suite of information which is publicly available to ensure it remains fit for purpose.

---

\(^2\) 2015 annual report - Transnational Giving Europe
ANNEX A

1. ICAS tax principles (local taxation$^3$)
   - Proportionate, reflecting ability to pay;
   - Simple to understand and transparent;
   - High collection rates, predictable revenues and difficult to avoid;
   - Clear accountability which connects decision making and spending of public funds with taxes raised;
   - Cost effective to administer;
   - A broad but balanced tax base
   - Best value (i.e. i.e. a duty to be neither profligate in the spending of public funds nor raising excessive tax revenues)
   - Stable and predictable revenues;
   - Aligned with current, not historic, needs and priorities;
   - A basket of taxes to minimise overloading one form.

2. Devolution of repatriated powers - principles to determine the decision basis for any devolution of new powers
   a. Achieve clear objectives, such as the speed of delivery of devolved powers to meet voters’ expectations whilst accepting trade-offs are likely to be necessary.
   b. Be transparent to voters, whether delivery is in the short term or managing expectations for the longer term.
   c. Avoid complex outcomes, by devolving powers whilst avoiding potentially problematic interactions with non-devolved powers.
   d. Minimise burdens on employers and businesses, because many taxes are collected at source and significant costs of administration could fall on those unpaid collectors.
   e. Maximise benefits in relation to costs for taxpayers, including assessments of HMRC’s/Revenue Scotland’s capacity and capability to deliver and the likely net revenue impact on Scotland’s finances.

3. Tax competition
   Tax competition is often viewed as one element that can be used to attract investment and encourage certain behaviours. However, there should be some caution as there can be downsides to tax competition such as:
   a. If a tax is devolved to Scotland but its tax base is not clear cut, then this can create significant new complexities and administrative burdens.
   b. Tax competition is usually effected by reducing rates or offering attractive reliefs from tax but this can encourage a damaging “race to

the bottom” between different jurisdictions which would reduce tax receipts for both the Scottish and UK Governments.

c. Tax competition can also lead to tax avoidance and tax planning. For example, tax can be more competitive in one jurisdiction compared to another in order to attract inward investment or the use of, say, a particular airport. The attraction to the potential taxpayer is a reduction in their tax bill, but it also encourages that taxpayer to avoid a less competitive tax. Equally, tax competition can be between different taxes. For instance, if corporation taxes are lowered there is an incentive for any unincorporated business to seek to convert sources liable to income tax into profits that are liable to corporation tax. In the eyes of some, this is also tax avoidance.

There will always be a balance to be struck between the desire for taxes that are specifically designed for local circumstances and local accountability, and which support the economy, but at the same time provide ease of administration for taxpayers, businesses that collect taxes on behalf of the state, and the tax authorities. Ease of administration tends to come from uniformity and certainty.

Tax competition can also become tied up with ‘no detriment’ debates if the competition in one part of the UK turns out to be detrimental to another part. At the heart of the ‘no detriment’ principle is the notion that the impact of policy decisions taken in one part of the UK do not impact adversely on the funding of public services in another part. Arguably, the ‘no detriment’ principle runs counter to encouraging tax competition.

4. Customs duties

The EU is both a single market and a customs union. There are no customs duties between EU member states. They share common external tariffs with third countries, and the EU has negotiated free trade agreements with some 34 non-EU countries throughout the world.

When Brexit takes effect, the UK will probably cease to be part of the EU customs union. Unless agreement is reached to the contrary, the EU could then be expected to apply customs duties to imports from the UK, making them more expensive and less attractive for EU businesses and consumers. Likewise, the UK might apply customs duties to imports from the EU, adding costs for UK businesses and consumers.

As a country outside the EU customs union, the UK would no longer benefit from the EU’s existing free trade agreements with non-EU countries. Thus they too could be expected to apply customs duties to imports from the UK, and the UK might apply customs duties to imports from them.

Where the benefit of the EU customs union is lost or trading arrangements with third countries are changed, the implications could extend far beyond customs duties alone. Additional customs procedures might be imposed on each occasion goods are exported from one country and then when they are imported to another, adding significant time, complexity and cost for the businesses concerned.
In our view there is unlikely to be a sudden switch from EU membership to a plethora of new free trade agreements with the EU and other countries. It is much more probable that new arrangements will evolve gradually over an extended period of time. This could create significant ongoing uncertainties for UK businesses with overseas suppliers or customers, as they may have to cope not only with changes to customs duty rates but also with multiple changes to customs clearance procedures and business system requirements.

5. Value added tax

The existing value added tax (VAT) is essentially a European tax, it is levied throughout the EU and is a key feature of the European single market. When the UK leaves the EU, it might still remain as a member of the single market with obligations to continue complying with EU VAT law. Alternatively, the UK might negotiate an arrangement where it would probably fall outside EU VAT law.

Similar value added tax regimes exist worldwide – in 135 non-EU countries, and in all OECD member countries except the USA. A value added tax meets modern fiscal requirements and in recent years most developed countries have shifted their fiscal balance, relying less on direct income taxes and more on indirect consumption taxes such as VAT.

From a government perspective VAT is a relatively efficient tax, relying heavily on businesses to act as tax collectors. It is unlikely that the UK would have the resources or inclination to legislate for a new value added tax and therefore it is probable that the existing VAT would remain in place, broadly unchanged, but over a longer period may evolve into a value added tax that is subtly different from the current VAT.

Any value added system that is no longer an EU VAT as part of the single market will inevitably give rise to changing administrative burdens, much of which is undertaken by businesses. So, for instance, Intrastat and the collection of trade statistics, EC sales lists, and import and export rules would be affected. UK businesses required to register for VAT in EU member states may also find increasing levels of administration.

The Scotland Act 2016 provides for a proportion of VAT to be assigned to the Scottish Parliament so if there were any changes to VAT and the amounts collected this could impact on Scottish revenues.

6. Direct taxes for international businesses

The main tax of interest is corporation tax, which remains a UK tax; there are no delegated powers, or proposed delegated powers, to Scotland in relation to corporation tax.

More broadly, there has always been considerable scope for the UK to set its own direct tax policies but in terms of ‘international tax’ the UK has been in a leadership position in the Organisation of Economic Cooperation and Development (OECD) discussions on Base Erosion and Profit Shifting (BEPS) so it is expected that such considerations would remain relevant.
In terms of the EU, the consequences of ‘Brexit’ are mainly with international groups that operate in the different EU states including the UK, and UK holding companies. They face the potential loss of the use of the Parent-Subsidiary Directive, which may mean that dividends can no longer be paid without withholding taxes; and the Interest and Royalties Directive which, again, may lead to withholding taxes becoming payable.

Measures may be required to make sure the UK, and Scotland, are attractive inward investment locations. The UK’s decision to leave the EU raises fundamental tax questions for multinational businesses. One of these is the continuing suitability of the UK as a holding company location after its eventual departure from the EU.