

The Chartered Institute of Taxation

Application and Professional Skills

VAT and Other Indirect Taxes

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Suggested answer

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Dear Bernie,

Acquisition of Targera Ltd

Thank you for your letter dated 30 April 2024, with enclosures, concerning a possible acquisition of the business of Targera Ltd ("T Ltd") by ABundle Ltd ("AB Ltd"). Discussions between you and Charlie, the majority shareholder in T Ltd, are at an early stage. In order to move matters forward, however, you have requested my initial thoughts on any likely tax issues.

This letter summarises my views based on information you have provided, material held on our client file and on current tax legislation and practice. This letter is for the sole use of AB Ltd and may not be relied on by any other person. In any business acquisition the seller and buyer are likely to have different aims. I am assuming AB Ltd wishes to achieve the optimum chance of profit at the least cost and risk to itself and I have advised accordingly. The other parties to the proposed transaction, namely T Ltd, Charlie and Gabriela Krell, should seek independent advice.

Overview

Relevant taxes are VAT, corporation tax and stamp taxes. The matter is complicated by the fact that T Ltd is VAT-registered but AB Ltd is not currently entitled to be registered because its supplies of gaming are VAT-exempt. Taxes on income and employment may also be relevant if an employment relationship arises.

There are five areas to consider:

- 1) Liability/entitlement to VAT registration.
- 2) Structuring the acquisition.
- 3) Trading losses.
- 4) Historic VAT claims.
- 5) Merged Business.

I shall consider each area in turn, identifying the respective tax issues. My conclusions and recommendations are provided at 6) and 7) below. It is premature to advise on valuation or pricing, but one of my colleagues can assist with this aspect at the appropriate time. I trust, however, that my tax analysis will help you progress discussions.

1): Liability/entitlement to VAT registration

A business whose taxable supplies exceed the VAT registration threshold of £85,000 per annum must register with HMRC and charge VAT on taxable supplies. A business trading below the threshold may apply to HMRC for voluntary registration. Similarly, where a business is being carried on with the intention of making taxable supplies in the future, it may apply for registration as an "intending trader". Where two or more businesses are under common control and at least one of them involves making taxable supplies, they may apply to HMRC for a VAT group registration. The group is then treated as a single taxable person trading through a nominated company (called the "representative member").

I will explain below how these rules apply to AB Ltd according to how you decide to structure the acquisition.

2): Structuring the Acquisition

In principle, there are two options open to AB Ltd:

- a) purchasing the shares; or
- b) purchasing assets,

and each creates different tax treatments.

a) Share Purchase

By disposing of their shares, Charlie and Gabriela would no longer control the company or its assets and AB Ltd would acquire all T Ltd's rights and liabilities.

VAT

A transfer of shares does not attract VAT. T Ltd would continue to be registered for VAT under its existing VAT number. However, because the acquisition costs, e.g., professional fees, would be incurred on supplies made to AB Ltd rather than to T Ltd, any related VAT would not be recoverable if AB Ltd remained unregistered.

AB Ltd could apply to register prior to the acquisition as an intending trader if it can show it is intending to make taxable supplies, such as providing T Ltd with management services. This may achieve VAT recovery, although HMRC are likely to refuse registration unless the services are genuine, supported by a proper Management Services Agreement and charged at a realistic level. A VAT grouping would not of itself entitle AB Ltd to recover VAT on acquisition costs. A practical alternative would be to incorporate a special purpose company to make the acquisition ("Newco") and I consider this further below.

Corporation tax

A purchase of the shares by AB Ltd would be an investment activity, and therefore a capital expense. As AB Ltd is a trading company, acquisition costs are not deductible for corporation tax as they are not incurred wholly and exclusively for the purposes of AB Ltd's trade. Where at least 75% of share capital is acquired, the companies together comprise a corporation tax group. In principle, group relief is available enabling one group member to surrender tax losses to another member, which I consider in detail at 3) below.

Stamp taxes

Shares are transferred by a share transfer instrument. The purchaser must register the transfer and pay stamp duty at the rate of 0.5%, calculated on the consideration agreed for the transfer of the shares. This includes non-monetary consideration and any arrangement for payment of a further sum, subject to a specified minimum or maximum, conditional on the company's future profits (known as an "earn-out"). Duty is then calculated on the sale price plus the maximum earn-out specified. No duty is chargeable where shares are transferred for an issue of new shares and HMRC give an adjudication. Any stamp duty paid is non-deductible for corporation tax but will be an allowable expense in computing any gain or loss on disposal of the shares, (unless, on disposal, the substantial shareholding exemption applies).

b) Asset Purchase

One option is to acquire all the assets as distinct from the shares. Another option is to acquire only certain assets.

VAT

Each option attracts a different VAT treatment. In principle, where assets are disposed of on a winding-up, they are deemed to be business supplies and VAT is potentially due. However, where all the assets (or sufficient of them to carry on the business) are transferred to a person intending to carry on that

business, this is known as the transfer of a going concern (“TOGC”). If certain conditions are met, a TOGC is treated as neither a supply of goods nor a supply of services and no VAT is due. At first sight this course may seem attractive.

An important condition, however, is that the transferee must already be a taxable person or immediately become, as a result of the transfer, a taxable person (“the taxable person test”). A taxable person is a person who is, or who is required to be registered for VAT. In deciding whether this test is met, the turnover of the transferor counts towards the registration threshold. As AB Ltd makes no taxable supplies and T Ltd’s turnover has fallen below the threshold, the taxable test would only be met here if, before the transfer, AB Ltd were to obtain VAT registration as an intending trader. This is usually a formality, though HMRC sometimes raise queries which may cause delay. Other conditions must also be satisfied, namely: the transferor must be a going concern at the date of transfer; assets transferred must be sufficient in nature to enable the transferee to continue operating the business; the business must be the same kind of business as that previously carried on by the transferor. These cases are fact-sensitive and a challenge by HMRC cannot be ruled out. It is unhelpful that HMRC are no longer willing to give advance rulings on whether the TOGC tests are met.

You may prefer, for commercial reasons, to acquire only selected assets. In principle, each forms a separate supply of either goods or services. The supplies may have different VAT liabilities. For example, tangible assets such as tools and equipment, are generally standard rated (taxable at 20%). Intangible assets, such as licences/ contracts and IP, are also standard rated. A sale of debtors is VAT-exempt. A transfer of a staff is not subject to VAT unless monetary consideration is specified. Both the vehicle and the Console House premises are leased. The vehicle lease could only be acquired if the lessor, Bookers plc, agrees to an assignment. The Landlord will demand a premium if the tenancy is either assigned or terminated. As the Landlord has opted to tax the property, VAT at 20% would be chargeable on the premium and on rent and service charges

A purchase of assets, as distinct from shares, would not transfer T Ltd’s VAT registration. It follows, therefore, that VAT incurred on purchasing assets (assuming the TOGC conditions are not met) would be a cost. This raises again the issue of VAT registration. Rather than registering AB Ltd, you should consider whether the acquisition could best be managed through a separate company (“Newco”).

Newco

Newco would be a wholly-owned subsidiary of AB Ltd, incorporated for the purpose of acquiring and carrying on the new trade. Incorporation involves some administrative and compliance costs. However, these are to be weighed against the advantage of simplicity and ring-fencing any tax and commercial risks, as Newco and AB Ltd would be regarded as separate legal persons. Newco would register for VAT as an intending trader. This would, in principle, entitle full deduction of VAT on all costs of acquiring the assets and carrying on the taxable business.

Corporation tax

Capital allowances may be available on the purchase of fixed assets. The 100% Annual Investment Allowance would not be available as T Ltd is a connected company.

Stamp taxes

No stamp duty is payable on any of the balance sheet items listed by Charlie. In principle, stamp duty land tax (“SDLT”) is chargeable on a land transaction such as the assignment of the premises lease. However, if AB Ltd decides to take an assignment of the lease, the premium indicated would fall within the nil rate band, so no SDLT is chargeable.

3): Trading Losses

You have asked specifically whether AB Ltd could utilise T Ltd’s tax losses to reduce its gaming profits for corporation tax purposes. This issue only arises if shares are purchased, as distinct from assets. In principle, where a single company makes a loss in an accounting year (“the loss period”), it may claim the loss against other non-trading profits made in the loss period, then carry back any unrelieved loss to the preceding year. Any unused part of the loss may then be carried forward and claimed against

future profits. Alternatively, the whole loss may be carried forward. Assuming T Ltd had no other profits in the loss period, it could carry back £75,000 of its loss to 2021/22. HMRC would refund £14,250, assuming a corporation tax rate of 19%. The unused loss (£25,000) could then be claimed against profits in future years. If a company ceases to trade, terminal loss relief may be claimed in order to carry back losses for up to three years. Time limits apply.

An obvious difficulty here is that it is uncertain when, or if, T Ltd will return to profit.

A further option is available where the loss is incurred by a company which is part of a group for corporation tax purposes. Unfortunately, anti-avoidance rules apply to prevent “loss-buying” as the motivation for buying a company.

These rules provide that losses incurred by a company joining a group may only be group-relieved in periods after the date of joining. A claim may have to be deferred for five years. Likewise, if ownership of the company joining has changed or there is a major change in its trade, such as switching to a new product or changing from wholesale to retail. Losses incurred after the date of such a change cannot generally be carried back; nor can they be carried forward where, before the change, the company's trade was small or negligible but has undergone a subsequent revival. The effect of these rules is that AB Ltd would not be entitled to claim group relief against its gaming profits for historic losses incurred by T Ltd; nor would T Ltd's ongoing losses be available for group relief against AB Ltd's profits were HMRC to consider that the trade of T Ltd was negligible before the acquisition or that it underwent a major change in its nature after the acquisition.

4): Historic VAT Claims

You also mention the VAT claims.

Under a share purchase the purchaser would acquire T Ltd's rights to make historic claims for VAT overpaid/ underclaimed. In the case of an asset purchase, however, such rights would not be acquired without a specific assignment in writing.

Different procedures apply depending on whether the claim is for output VAT or input VAT; but, in either case, time limits apply. Here, the duplication of output VAT of £10,000 occurred on T Ltd's VAT return for the period ending 30 April 2020. As this is now outside the 4-year time limit, any claim is time-barred and will fail.

Input VAT of £3,000 could not have been lawfully deducted in the April 2020 return because no VAT invoice was held. A lawful deduction could have been made in the next VAT return but was not. Under regulation 29, HMRC allow claims to be made within 4 years of the end of the period in which a lawful claim could have been made. As the claim falls within the error correction limits, Method 1 must be used and the claim made on a VAT return. Any claim, however, will be out of time unless made by T Ltd within 4 years of the end of its July 2020 VAT period. This may present practical difficulties. An assignment of the right may not be effective as HMRC's refund procedure is geared to a claim made by the taxable person who actually overpaid/ underclaimed the VAT.

5): Merged Business

I will now consider the VAT issues arising for the business following the acquisition.

VAT

T Ltd's current supplies (software licences supplied to a UK distributor) are now in run-off. While they continue, fees received are standard rated. If the shares are purchased, T Ltd will remain VAT-registered unless it ceases to make, or to have the intention of making, taxable supplies altogether. In the case of an asset purchase, these supplies will continue to be standard rated only if the acquirer is VAT-registered.

The same will, in principle, apply for supplies made under Project Z. Assuming these are supplied exclusively online, they are referred to as “electronic” or “digital” services. If supplied to a UK distributor, they will be standard rated. If supplied to a distributor established outside the UK, they will count towards

taxable turnover but any VAT due is accounted for by the distributor under the “reverse charge” mechanism.

Charlie, however, has raised the possibility of cutting-out the distributor and supplying the new product direct to individual (non-business) customers worldwide. Special rules apply to determine the place of supply and hence the liability to account for VAT. In summary, if the non-business customer’s place of belonging (i.e., normal place of residence) is:

- 1) in the UK, VAT must be charged;
- 2) outside the UK or EU, no VAT is charged (though some countries may apply local tax);
- 3) in an EU Member State, the VAT applicable in the customer’s home State must be charged. This can be dealt with in one of two ways:
 - by registering for VAT in every single affected Member State, or
 - by signing- up to the Non-Union One-Stop-Shop Scheme (“the OSS”) in a chosen EU Member State. A single composite return is made, with that Member State remitting the appropriate amount of VAT to other Member States. However, the OSS does not enable reclaim of VAT incurred in EU Member States.

Charlie and Gabriela

You have asked me to highlight any obvious pitfalls, prior to discussions with Charlie. There are three ways they could share in the success of the business:

1. Shares;
2. Consultancy agreement;
3. Employment contract,

or a combination.

Under a share purchase, you could allow Charlie to retain a minority holding in T Ltd. In the case of an asset purchase, you could offer him shares in the acquiring company. However, if the acquirer is AB Ltd, you might not wish to give him a stake in your core gaming business. If the acquisition is by Newco, of course, there may be some delay before profits are earned and dividends paid. As already mentioned, if the consideration for the sale of T Ltd’s shares takes the form of an issue of new shares, you can request HMRC to give an adjudication. This could save stamp duty. Charlie may wish to be remunerated as Project Z proceeds. A consultancy agreement would best achieve this. It should be carefully drafted to avoid the risk of creating a business establishment in Spain.

An employment contract (which Charlie may already have with T Ltd) will involve rights under employment protection law as well as compliance issues in relation to employment taxes. Once Charlie moves to Spain, this could risk creating a business establishment there for tax purposes and should be avoided.

Unless Gabriela is included within Charlie’s arrangements, a licence agreement for use of her characters may be appropriate. Consultancy/ licence fees paid to a non-UK business are consideration for imported services which counts towards taxable turnover. Output VAT must be self-accounted under the reverse charge, but this will also give rise to input VAT recoverable under the normal rules. As such fees will be attributable to Project Z, the reverse charge will have a nil net VAT cost.

6) Conclusions

In general, your choice of structure should be driven by commercial, rather than purely tax, considerations. Success of Project Z cannot be guaranteed and AB Ltd should aim to limit its own exposure and compliance burdens. For ease of reference, I compare below the two options.

Share purchase: advantages

T Ltd has an established name in the market. Acquiring the company would ensure AB Ltd acquires everything necessary to exploit Project Z. T Ltd is already VAT registered and this registration can be continued and thereby recover VAT on the costs of developing Project Z.

Disadvantages

When acquiring a company, the purchaser becomes liable for all its debts. There may also be latent liabilities. Given the need to maintain the relationship with Charlie (who is currently an officer/employee of T Ltd), warranties and indemnities may not be fully effective. AB Ltd will be encumbered with liabilities it may not want, e.g., creditors, the vehicle, premises, staff contract. A group relief claim and the historic VAT claims are likely to prove illusory. There is a stamp duty cost. The costs of acquisition are non-deductible for corporation tax and, if AB Ltd is the acquirer, VAT on acquisition costs will be irrecoverable.

Asset purchase: advantages

If you acquire all the assets, a VAT cost is avoided altogether provided HMRC accept TOGC treatment. If you acquire selected assets (e.g., only those necessary for Project Z) any VAT chargeable would not ultimately be a cost since it could be recovered through an intending trader registration. The relationship with Charlie can be secured through a suitably drafted consultancy agreement. It will be important to ensure that Charlie cannot engage in unfair competition. No stamp duty will be payable. Although I have not addressed goodwill in detail, one advantage of acquiring assets is it will enable goodwill on certain assets to be written-off to obtain a corporation tax deduction.

Disadvantages

T Ltd's VAT registration will not transfer and any VAT incurred will need to be recovered through an intending trader registration. TOGC treatment, if adopted, may be open to challenge by HMRC.

7) Recommendations

In light of my analysis, I recommend:

- a) instead of purchasing the shares, you acquire only those assets necessary for carrying on Project Z;
- b) incorporate Newco for the purpose, rather than acquiring through AB Ltd. The costs of incorporation etc., are likely to be outweighed by the advantages of simplicity and ring-fencing any commercial and tax risks;
- c) prior to incorporation, VAT-register Newco as an intending trader to maximise VAT recovery on the costs of acquiring and carrying on the trade;
- d) I can advise further on whether a VAT group should be formed between AB Ltd and Newco, depending on the level of any inter-company supplies;
- e) if electronic services are to be supplied to non-business customers resident in EU Member States, an OSS registration will be required. The Republic of Ireland is suitable as this will ease administration and avoid language difficulties;
- f) a carefully drafted consultancy agreement will best cover Charlie's involvement in, and remuneration for, the Project.

I hope I have answered all your questions and should be happy to advise further as negotiations proceed.

Yours sincerely,

Amal

Amal Patel, Tax Manager