



The Chartered Tax Adviser Examination

May 2019

Application and Professional Skills

VAT and Other Indirect Taxes

Suggested solution

Report to the Board of Kure Leisure plc

1 Scope of report

In accordance with your instructions contained in our terms of engagement issued on 3 May 2019, this report covers:

- (a) Our recommendation on the method of acquisition of the business Target Ltd.
- (b) Identification and quantification of misstatements of Target Ltd's corporation tax and VAT liabilities in the recent past based on your due diligence findings.
- (c) Our recommendations regarding Target Ltd's accumulated tax losses.
- (d) The tax treatment of capital expenditure of £1.1 million relating to the upgrading of Target Ltd's parks following the acquisition.

Our report is based upon the information contained in Mr Franklin's letter of 1 May 2019. In accordance with our agreed terms of reference. Firstly, we have not undertaken any further enquiries into the information provided and, secondly, our report has been prepared solely for the benefit of Kure Leisure plc. Accordingly, its contents may not be disclosed to a third party without our prior written consent.

In this Report, unless otherwise stated, "Kure" refers to Kure Leisure plc and its group companies.

2. Executive summary

Our findings and recommendations are as follows:

2.1 Structure of acquisition. Although a purchaser will generally favour the purchase of a company's assets and business, here we recommend that Target Ltd's shares be purchased for the following reasons (see section 3.1):

- (a) the stamp duty land tax charge ("SDLT") on the acquisition of Target Ltd's land interests is £281,400 (we refer you to Annex A for a computation of the charge) based on their estimated value of £6.15 million. In contrast, the stamp duty charge on purchasing the shares for £6.75 million will be £33,750 on the basis that only a nominal value is attributable to Target Ltd's tax losses - see section 5.
- (b) a share purchase coincides with the expressed wishes of Target Ltd's shareholders, thereby increasing the likelihood of a successful conclusion to negotiations, with perhaps scope to strike a lower price.

2.2 Understatements of VAT identified. HM Revenue and Customs (HMRC) are empowered to raise assessments going back four years. We have estimated understatements of VAT in the last four years totalling £339,150, plus interest and possibly penalties, as follows:

- (a) £134,600 relating to the standard rated contents of zero-rated caravans, principally attributable to: Target Ltd's narrow interpretation of "removable contents" (section 4.2); its valuation of the contents of new caravans; and incorrect application of the second-hand goods scheme to resale of certain used caravans (section 4.2).
- (b) £134,550 on the provision of unmetered electricity and water and sewerage services supplied to caravan owners (section 4.3).
- (c) Up to £70,000 on chalet licences at Woodcombe Heights (section 4.4).

While the nature of the understatements of VAT which have been identified militate against the purchase of Target Ltd's shares, on balance we consider this is the preferable option, but

we recommend that Kure seek additional assurance from Target Ltd in line with our suggested approach as explained in section 4.5.

2.3 Target Ltd's claim for deduction of the resurfacing expenditure incurred at Woodcombe Heights park is correct (section 5).

2.4 A nominal sum only should be attributed to Target Ltd's accumulated tax losses, given that anti-avoidance legislation has largely nullified any value previously attached to them (section 6).

2.5 A significant part of the proposed capital expenditure of £1.1 million on rebranding the restaurant and bar outlets and upgrading the swimming pools may be treated as expenditure on plant. This is eligible for the annual investment allowance (currently £200,000) with the balance allocated to the general pool (writing down allowances currently 18%). Systems integrated in the swimming pool buildings could be eligible for writing down allowances at the rate of 8% as special rate pool assets (section 7).

2.6 Target Ltd should be added to the existing VAT Group and the partial exemption special method revised so that its activities are incorporated into the holiday park sector (section 8).

3 Structure of acquisition

3.1 Asset purchase compared with share purchase

A successful outcome to the acquisition of Target Ltd requires appreciation of its shareholders' preference for a share sale. A share sale will avoid the potential double tax charge on an asset sale occasioned by firstly, a charge to corporation tax on the chargeable gains and balancing charges arising on the transfer of assets by Target Ltd and, secondly, the charge to income tax suffered by shareholders on dividends paid out of the profits accruing from the sale. Invariably, the income tax rates will exceed the flat rate chargeable on capital gains. This may be particularly so in the case of Dennis Wills. As the largest shareholder, his personal tax position is highly likely to be material to the price struck for the business and a successful outcome.

Key advantages of an asset purchase are:

(a) Kure will not take on Target Ltd's tax or other liabilities (so the detailed due diligence normally associated with quantifying such liabilities is avoided). A number of VAT related issues have already been identified through the due diligence process.

(b) Capital allowances will be available on the price ascribed by the parties to plant and machinery rather than Target Ltd's tax written-down value, but in the case of fixtures, a joint election is required and the price agreed by the parties will be limited to Target Ltd's qualifying expenditure. Alternatively, Kure could apportion a value to fixtures on a just and reasonable basis and, within two years of the purchase, apply to a Tax Tribunal to affirm its valuation.

(c) Land and fixed plant and machinery acquired may constitute replacement qualifying assets, thereby allowing Kure to defer chargeable gains arising on assets disposed of in the last three years or in 12 months following acquisition.

(d) The base value of trading stock (particularly caravans) will be that agreed by the parties. Accordingly, profit on its sale by Kure will be computed by reference to the agreed value rather than Target Ltd's historic cost, with Target Ltd's stock on hand at the end of Kure's accounting period written-down in accordance with its accounting policy.

(e) Kure can choose which assets it acquires. That said, identification of the assets and their transfer can be a time-consuming and onerous process with perhaps an uncertain outcome. For example, supplier contracts may have to be novated, the approval of the owners of leased assets could be required, etc.

(f) Perhaps significantly, to the extent that gains will crystallise on the transfer of capital assets, for example, Target Ltd's interests in land, the tax liability will rest with it, with Kure benefiting from the increased base value. In contrast, on a share purchase, Kure will acquire the assets at historic cost and unless future realised gains can be rolled over, Kure will assume the tax on the gains attributable to Target Ltd's period of ownership.

Key advantages of a share purchase are:

(a) Stamp duty at a rate of 0.5% on the indicative price of £7.05 million for the shares is modest compared to the SDLT rates applicable to Target Ltd's land interests.

(b) The acquisition of Target Ltd's shares will be exempt from VAT, with VAT incurred on associated costs deductible at the recovery rate applicable to VAT incurred on Kure's general overheads. Also, the risk of a selected purchase of assets not being seen as a transfer of a going concern is avoided; however, adjustments on assets within the Capital Goods Scheme will continue, with a new interval beginning on the VAT grouping of Target Ltd with Kure.

In contrast, where Target Ltd's assets are acquired, although the transaction is likely to be regarded as a transfer of a business as a going concern (and accordingly outside the scope of VAT), Kure will need to satisfy itself that irrecoverable VAT does not arise on account of the deemed supply and re-acquisition of assets outside the scope of the Capital Goods Scheme. The deeming provision is unlikely to arise so long as our recommendation in section 8 is followed since Kure will be entitled to full credit for VAT incurred on the assets acquired.

(c) The acquisition of accumulated trading losses (but see section 6).

(d) The avoidance of the administration associated with the transfer of contracts of employment and determination of employee accrued entitlements and benefit plans.

3.2 Conclusion and recommendation

Taking account of the above matters, we recommend that Kure purchases Target Ltd's shares, rather than its assets for the following reasons:

(a) A tax saving of £261,750 could be achieved. The stamp duty on the indicative consideration of £7.05 million is £35,250 compared to the SDLT chargeable on the land (being £297,000). If the losses have only a nominal value, then the stamp duty liability would reduce to £33,750. Assuming multi-dwelling relief (see Annex A for the computation) is claimed, the saving would reduce to £247,650 but this is still more beneficial than the assets purchase. While there may be some scope to mitigate this differential were Kure to purchase Target Ltd's assets (for example, the scope for uplifted capital allowances on plant and machinery acquired), there is every likelihood that an uplift in the value of such assets will result in an increased tax charge in Target Ltd.

(b) Were Kure to press for the purchase of Target Ltd's assets, there is a possibility its shareholders will look to increase the price to cover their own tax liabilities.

4 VAT understatements

As highlighted by the due diligence, Target Ltd has made certain VAT errors, which we consider in turn.

4.1 Caravans - scope of standard rated removable contents

Static caravans are zero-rated if they meet the required British Standard conditions. Zero rating extends to fixtures and fittings of a kind normally incorporated by a builder into new dwellings, for example: sinks, WCs, showers, kitchen units, etc. The caravans etc will be chargeable to VAT at the lower rate of 5% where they do not meet the required British Standard. We have assumed the caravans have met the required British Standard for the purpose of this report but this fact should be verified.

Irrespective of whether the caravan is zero rated or lower rated, other fixtures and fittings incorporated into a caravan, along with loose furniture and furnishings (“removable contents”), are standard rated even when supplied with the caravan. Where, as has been identified in the case of Target Ltd, it has adopted a narrow interpretation of “removable contents”, inevitably it will result in an understatement of VAT on the sale of caravans - this aspect is covered in greater detail in the section 4.2(b).

4.2. Valuation of “removable contents”

Where a zero-rated caravan is sold together with removable contents excluded from zero-rating, the supplier must apportion the consideration in a fair and reasonable basis and pay VAT accordingly.

(a) New caravans

Under HMRC's published guidance, Target Ltd could have adopted the 4% apportionment used by manufacturers (provided it was strictly limited to fixtures and fittings of a kind ordinarily installed by a builder in a dwelling, was fair and reasonable and was supported by evidence). However, assuming no additional contents were added, the same apportionment should have been applied to the full resale price (i.e. not limited to the price before Target Ltd added the 45% uplift). Accordingly, in the last four years, Target Ltd understated its liability by $£23.2 \text{ million} \times 4\% \times 20\% = £185,600$ less $£128,000$ VAT already paid. VAT underdeclared is $£57,600$.

(b) Used caravans

In the case of caravans purchased from manufacturers, Target Ltd has adopted too wide a view of what is allowable as a fixture or fitting by including items which are “removable contents” (such as ‘fridges, cookers, blinds and loose furniture). All items introduced into the core or shell are inherently removable. The independent valuation appears to have been carried out on a flawed basis and, in our view, cannot be relied upon as supporting evidence. It follows that the apportionment of 2% in respect of “removable contents” is far too low. In the absence of other credible evidence, therefore, the methodology agreed between HMRC and the trade associations should have been used. Therefore, for caravans originally acquired from manufacturers, VAT should have been calculated on 10% of the full VAT inclusive sale price. The second-hand goods scheme is not available as, presumably, the caravans were originally purchased on a VAT invoice issued by VAT-registered manufacturers. Accordingly, in the last four years, Target Ltd understated its liability on resold caravans purchased from manufacturers by $£40,000$, the calculation being: $£3 \text{ million} \times 1/6 \times 10\% = £50,000$ less $£10,000$ VAT already paid. VAT underdeclared = $£40,000$.

Where caravans were acquired from non-VAT registered persons (for example, where taken in part-exchange) and then resold, Target Ltd made the same error of apportionment. The second-hand goods scheme may be adopted as the removable contents qualify for the scheme. However, the scheme must be applied on a caravan-by-caravan basis. Instead, Target Ltd appears to have used the Global Accounting Scheme which is only permissible for certain small value items. Taking the December 2018 VAT period, therefore, the VAT-inclusive margin on 15 caravans was $£172,000$. Adopting HMRCs' published methodology, VAT underdeclared was $£2,326$, calculated as follows: $£172,000 \times 1/6 \times 10\% = £2,866$ less $£540$. No VAT was due on the 5 ‘nil’ margin deals but no netting-off is permitted. Since it is likely that this error has been replicated over the last 4 years, Target Ltd may have understated VAT due of the order of $£37,000$.

4.3 Supplies of unmetered fuel and power, water and sewerage services

Since Target Ltd's charges are not based on identified supplies made to caravan owners, it is clear from case law that they are not separate supplies and are therefore to be treated as part of the supply of the pitch. Accordingly, the weekly fixed charges are standard rated. Given that Target Ltd accounted for VAT on supplies of fuel on - it has been assumed - a VAT exclusive basis, VAT understated on these supplies in the last four years was $£87,750$ ($£5 \times 750 \times 39 \text{ weeks} \times 4 \text{ years}$) $\times (20 - 5\%)$, with the understatement on supplies of water and sewerage being $£46,800$ ($£2 \times 750 \times 39 \text{ weeks} \times 4 \text{ years}$) $\times 20\%$.

4.4 Chalet licences

The supply of a seasonal pitch for a caravan (we are advised that the chalets qualify as "caravans" for VAT purposes) is standard rated; a seasonal pitch being a non-residential pitch which is provided for more than a year, is subject to an occupation restriction and is not intended to be used as the occupant's principal place of residence during the period of occupancy. An occupation restriction includes any statutory planning consent which precludes the occupant from occupying the pitch by living in a caravan at all times throughout the period of the licence.

It is clear from case law that Local Authority knowledge of the breach of a planning covenant, and its reasons for not taking enforcement action, are irrelevant. There is no basis for saying that the condition has lapsed. It continues to subsist until the end of the enforcement period under planning law; therefore, until then the pitches are subject to an occupation restriction. Accordingly, depending on the number of occupiers who breached the occupancy restriction, licence fees were liable to VAT. Target Ltd's understatements could therefore be as much as £70,000, being £420,000 x 1/6.

4.5 VAT conclusions and recommendation

We have concluded that, over the last four years, Target Ltd has understated VAT by as much as £339,150. We recommend that Kure:

- (a) raises these issues immediately with Target Ltd, requesting it to make a voluntary disclosure to HMRC and to settle VAT due, plus interest and penalties where relevant. All working papers should be provided to Kure before the disclosure is made;
- (b) if Target Ltd is unwilling to do this, the acquisition price should be reduced to cover all such liabilities (including any related professional costs);
- (c) in any event, given Target Ltd's poor compliance, its shareholders should be required, as a condition of sale of the shares, to provide Kure with suitable warranties and indemnities;
- (d) consider holding part of the purchase price in escrow until matters are resolved.

In so recommending, we have considered the possibility of Target Ltd hiving down its trade (along with the transfer of its assets) to a newly formed subsidiary company ("Newco") untainted by these tax liabilities (along with perhaps penalties, interest and further liabilities). We have discounted this option because it is unlikely to be attractive to the parties for one or more of the following reasons: there has to be a reasonable gap between the initial hive down and Kure's acquisition of Newco's shares, the anti-avoidance rules set out in the following section would apply equally to Newco, the recommendations set out above may well meet Kure's commercial requirements and finally, Target Ltd very probably will incur additional tax liabilities on the de-grouping of Newco.

5 Target Ltd's accumulated tax losses

Anti-avoidance rules restrict relief on brought forward losses where, within any 5-year period, there is both a change in a company's ownership (on this account, our observations on this issue only apply to a share acquisition) and a major change in the nature or conduct of its trade. Since the five-year period encompasses any period, HMRC will have regard to changes which occurred before a change in ownership took place. A major change encompasses significant changes in the services or facilities provided, or in customers, outlets or markets. The possibility that these restrictions could be overcome by Kure transferring Target Ltd's trade, together with its losses, to another group company has also been restricted by anti-avoidance legislation.

Unless Kure is certain that Target Ltd's trade is inherently profitable without any significant change in the manner in which the business is conducted, it should be cautious about paying £300,000 for these losses. The anti-avoidance legislation is so broadly drafted that it has the

potential to influence Kure's future business decisions; accordingly, we recommend that the value attributed to the tax losses should be nominal, say £1. Alternatively, part of the purchase consideration should be deferred pending utilisation of the losses.

6 Deduction claimed for resurfacing expenditure – Woodcombe Heights

In assessing profits chargeable to corporation tax, capital expenditure is not deductible. Thus, firstly, we have to identify the entirety of the subject involved. Where the whole or a substantial part of the entirety is replaced, it is a renewal and the expenditure is capital. Where the replacement is less than the whole or a substantial part, we have to consider if the entirety has been improved; if so, the expenditure is capital.

We consider that the entirety of the subject matter is the whole of Woodcombe Heights park, not the individual touring caravan pitches. On the facts presented, the pitches are both physically and commercially an integral part of the larger enterprise of the holiday park.

Given that the replacement surface related to less than the whole, or a substantial part, of the park, we have to ask ourselves if the expenditure resulted in their improvement. On the facts, the answer is no. Although a like-for-like replacement is absent, the grass surface had been in situ for 30 years, commercial considerations dictated an alternative surface be installed at minimum disruption to the business and it is highly unlikely that the new surface materially resulted in an increase in the value of the park.

Of course, HMRC may take a contrary view and there may be a considerable delay before the issue is settled, particularly if it were the subject of an appeal to a tax tribunal. If the matter were not to be resolved in favour of Target Ltd, given its accumulated trading losses, it is unlikely to result in a tax liability but that would impact on the value of the losses.

7 Future capital expenditure

Generally, there is no tax relief on capital expenditure incurred on the construction of a building, the incorporation of an asset within, or connected to a building, and the provision of a structure, or works involving the alteration of land.

Building-related expenditure in the nature of: (a) decorative assets intended to create an atmosphere/ambience in support of Kure's bar and catering operations; and (b) part of the costs associated with the construction of the indoor swimming pools will be seen as plant eligible for the annual investment allowance (currently it attracts a deduction of up to £200,000 per annum), with unrelieved expenditure incurred in an accounting period eligible for capital allowances as part of the general pool, attracting an annual writing-down allowance of 18%.

Since the rebranding expenditure will be spread over a number of outlets, consideration should be given to either Kure approaching HMRC to secure its agreement to a limited sampling exercise or alternatively engaging a suitably experienced surveyor to quantify the qualifying expenditure applying to all outlets.

In relation to the swimming pools, the demolition of the existing facilities, excavation, pool construction, terracing, acquisition and installation of plant associated with delivery of heating and purification of the water and related professional costs are considered to be plant, attracting a writing down allowance of 18%, but not the construction of the buildings housing the swimming pools. Expenditure relating to a limited range of items integrated in these buildings, for example, central heating, hot water and air-conditioning systems, alarms and sprinklers will qualify for the special rate writing-down allowance of 8%.

8 Incorporation of Target Ltd in existing VAT Group

On acquisition, for ease of administration, we recommend that Target Ltd be added to the existing VAT Group and the existing partial exemption special method be revised so that its activities are incorporated into the holiday park sector.

Peters Mason LLP

9 May 2019

**Report to Board of Kure Leisure plc
Projected SDLT charge on Target Ltd's interests in land**

Annex A

	£
Projected consideration for freehold interest in non-residential land, excluding staff flats	5,370,000
Projected consideration for freehold in staff flats	<u>780,000</u>
Total consideration	<u>6,150,000</u>
SDLT chargeable on transfer of freehold interest in non-residential land Where the subject of a single transaction, the transfer of a major interest in six or more dwellings is to be treated as non- residential property:	
Up to £150,000	0
£150,001 to £250,000 @ 2%	2,000
£250,001 to £6.15m @ 5%	<u>295,000</u>
	<u>£297,000</u>
SDLT chargeable if multi-dwelling relief claimed:	
(1) SDLT chargeable on staff accommodation valued at £780,000: (780,000/12) x 3% = £1,950. Liability on 12 flats	23,400
SDLT chargeable on non-residential land interests valued at £5.37m	<u>258,000</u>
	<u>£281,400</u>

ASSESSMENT NARRATIVE

Structure

A simple pass or fail will be awarded.

Identification and Application

The following are the relevant topics for assessment with their weightings:

1	25%	Relevant merits of a purchase of shares v assets/business of Target Ltd
2	40%	Scope of the VAT treatment of removable contents of zero-rated caravans, supplies of unmetered fuel and power, water and sewerage services and seasonal pitches; conclusion on treatment adopted by Target Ltd and quantification of VAT errors (alternative conclusions based on an analysis of the law and practice will be accepted)
3	10%	Analysis and conclusion on treatment adopted by Target Ltd in relation to deduction claimed on resurfacing costs at Woolacombe Heights
4	5%	Valuation of Target's trading losses - identification and application of anti-avoidance rules.
5	10%	Scope for capital allowances on proposed capital expenditure - AIA, general pool and special rate WDAs and conclusion on whether expenditure represents plant and machinery
6	10%	Calculation of SDLT/SD charges

A grade of 0,1,2,3, or 4 is awarded to each topic. The weighting is applied to that grade to produce a weighted average grade. This is then converted to a final absolute grade by rounding up or down to the nearest grade. Thus, scores in the range 2.5 to 3.49 will be a grade 3. In this example, the candidate will score a grade 3 overall and secure a pass for this skill.

Relevant Advice and Substantiated Recommendations

The following are the topics for assessment with their weightings:

1	45%	Recommendation and advice that Kure to proceed with a share purchase, supported by relevant analysis and computation of relative SDLT/Stamp Duty charges. Recommendation to claim multi dwelling relief (NB an alternative recommendation will be accepted where supported with by relevant analysis and arguments)
2	35%	Options open to Kure given the VAT errors identified and quantification. Recommendation of VAT group and variation of partial method.
3	5%	Impact on purchase price of Target Ltd of HMRC enquiry into resurfacing work and advice how Kure might deal with issue
4	10%	Conclusion that only nominal value should be attached to losses and identification of alternative approach to Target's demand.
5	5%	Conclusion on potential capital allowances relief available and seeking HMRC's agreement to sampling

The final grade will be determined for this skill in the same way as for Identification and Application.