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Application and Professional Skills

VAT and Other Indirect Taxes

Suggested solution

DRAFT REPORT FOR ETIOLI CORP INC ON UK TAX ISSUES

INTRODUCTION

This report is prepared for Etioli Corp Inc ("ECI") based on information contained in an email dated 1 November 2019 from Ed Lerner to Phil Kappa of our US firm. It considers the UK tax issues relevant to ECI's proposals to set-up conference and distance-teaching businesses in the UK and to acquire London offices. Our advice and recommendations are confidential and for the sole use of ECI and its subsidiaries, Etioli Green Inc and Etioli Red Inc (together "the Group").

EXECUTIVE SUMMARY

1) There is a choice of two structures: setting-up a UK branch or incorporating a UK subsidiary. As the Group has developed the necessary expertise and will wish to continue its hands-on approach, we advise against a third possibility (namely, carrying on business through an agency/VAT representative).

2) The key taxes to consider are corporation tax and value added tax ("VAT"). Their impact is broadly similar as between branch or subsidiary, but with some differences regarding deduction of expenses for corporation tax and, for VAT, the treatment of transactions with the Group in the US.

3) The choice between a branch or subsidiary is essentially a commercial decision. However, for reasons we explain (in particular, avoiding ECI's exposure to UK tax, ease of administration and limited liability), we advise using a subsidiary structure.

4) In any event, a UK VAT registration will be required for the conferences (although not all supplies are within the scope of UK VAT). Distance-teaching will also require a special MOSS registration to account for VAT chargeable in EU Member States. VAT registration in Ireland may also be required.

5) Advice should be obtained from our Dublin office on the Irish tax position.

6) Purchasing the shares in Propmax (Aegis Court) Ltd will result in a saving of Stamp Duty Land Tax ("SDLT"). However, purchasing the freehold may be the safer route.

7) We recommend opting to tax the building. Income from sub-letting will be liable to corporation tax and VAT.

8) We also highlight the availability of various group reliefs.

For ease of reference, this report is divided into five sections:

A: Setting-up in the UK.

B: Conferences.

C: Distance-teaching.

D: Office building.

E: Group reliefs.

A: SETTING-UP IN THE UK

Corporation tax

The Group is not currently liable to corporation tax as no member of the Group is UK-resident or centrally-managed and controlled here. In principle, any of the Group companies could set-up a UK branch (acting as its head office). Alternatively, any Group company could incorporate a UK subsidiary (acting as its parent). It is possible to set-up a branch and later convert it into a subsidiary. Essentially, it is a commercial decision as to which Group company is chosen to set-up the UK entity; but, as the current business model is one where ECI is an active holding company managing two distinct trades, our recommendation is that ECI will occupy the role of head office/parent (and our report is drafted on that basis); but, equally, this role could be performed by either, or both, the US subsidiaries.

We have concluded that Phase 1 will not, by itself, give ECI a tax presence in the UK. No trade will be carried on at that point. Mr Capaldi will reside at his apartment and meet with other team members at a hotel. Acquisition of the office building (see section D), however, will immediately create a UK permanent establishment. HM Revenue and Customs ("HMRC") are likely to regard the building as a place from which a trade is being carried on. If ECI operates as a branch, this will bring ECI itself within the scope of corporation tax. ECI will be chargeable to corporation tax on any Phase 2 profits which are attributable to its UK branch. We recommend ECI seeks US tax advice on whether any losses in the UK branch may be allowable immediately against ECI's US tax charge. Alternatively, losses may be carried forward and set against the UK branch's taxable profits. Iirrespective of prices actually charged by ECI, transactions between ECI and its UK branch would be deemed to be at arm's length. No deduction would be allowed for interest or royalties charged by ECI to the branch. If ECI owns the building (either by purchasing the shares or the freehold) and it receives property income from letting the building, this by itself creates a tax presence subject to UK tax.

By contrast, a UK-incorporated subsidiary is a separate legal entity from its parent. Such subsidiary would be liable to corporation tax on its own profits or gains (and any property-letting income). Transactions between ECI and the UK subsidiary are subject to transfer pricing rules which require arm's length pricing. In principle, management charges and interest are deductible by the subsidiary. The payment of dividends should not be subject to withholding tax.

As regards Phase 3, it may be possible to carry on a separate distance-teaching trade based in the US, providing courses to customers in Europe, without exposing ECI to corporation tax. However, as the commercial wish is to establish a centre of excellence in the UK, we consider this will necessitate some form of permanent establishment. In any event, VAT registration will be required (see below).

VAT

VAT is a tax on supply of goods and services. In principle, VAT on supplies ("output VAT") must be collected from the customer and paid over to HMRC after deduction of VAT incurred on allowable expenditure ("input VAT"). Phase 1 will not involve making supplies and so a VAT registration will not be mandatory, though may be desirable (see recommendations below). As explained in more detail in sections B and C, Phases 2 and 3 will involve the making of supplies. Certain of these will be within the scope of UK VAT and VAT registration will be required. A branch is part of the same legal entity as its head office. If ECI uses a branch structure, therefore, registration will be in the name of ECI and ECI will be liable for keeping and preserving records and making them available for inspection. Transactions between head office and branch are not supplies for VAT purposes. VAT on expenditure is deductible as input VAT provided the expenditure is used, or to be used, in making taxable supplies. "Taxable supplies" includes supplies made outside the UK which would be taxable if made in the UK. A business genuinely intending to make future taxable supplies (an "intending trader") may immediately apply for voluntary registration and deduct input VAT (including, subject to certain limits, VAT incurred prior to its registration).

A subsidiary, however, is a separate legal entity from its parent and VAT-registrable in its own name. Transactions with an overseas parent can amount to supplies (see section B). This should not create a VAT cost for the subsidiary provided such transactions are used for its own taxable supplies (see also E below for VAT grouping).

Recommendations

The choice between a branch or subsidiary structure is essentially a commercial and operational one rather than tax-driven. However, given the importance to ECI of avoiding exposure to UK tax, and for ease of administration, we recommend incorporating a UK subsidiary, funded initially by a combination of debt and equity. Although using a branch may offer a cashflow advantage, this may not be significant if, as anticipated, the conference trade soon shows a profit. A subsidiary's limited liability is an important factor, since ECI would not be liable for the subsidiary's debts (except under any guarantee arrangements which it chose to enter into). For the same reasons, we recommend the UK subsidiary purchases the office building. For VAT, the subsidiary would register in its own name and be liable for its own VAT debts. This would simplify compliance and, assuming expenditure is incurred by the subsidiary for its own business purposes, reduce the scope for disputes with HMRC about input VAT deduction. We recommend early registration as an intending trader. This should enable recovery of certain Phase 1 expenditure provided it is incurred for the subsidiary's benefit or in connection with its incorporation. Note, however, that there is a cut-off for VAT incurred on services more than six months before registration. On the basis of our recommendations, we will refer to such a subsidiary of ECI as Etioli Green UK Ltd (hereafter "Green UK").

In theory, Green UK could also carry on the distance-teaching trade. However, if Phase 3 goes ahead, we recommend ECI incorporates a separate UK subsidiary rather than using a branch structure. This is for the reasons already given in relation to the conference trade. In addition, a separate subsidiary would reflect the current US business model and ring-fence any commercial risk from the new distance-teaching business. On the basis of our recommendations, we will refer to such a subsidiary as Etioli Red UK Ltd (hereafter "Red UK").

B: CONFERENCES

The issue of shares on incorporating Green UK is disregarded for tax purposes. Related costs (such as professional fees) are allowable deductions for VAT and corporation tax (except the cost of incorporation is disallowed for corporation tax as this is a capital expense). In principle, Green UK is entitled to deduct interest on loans for its trading purposes. Interest paid to ECI would, in principle, be liable to withholding tax (subject to relief under the UK/US Double Tax Agreement).

For corporation tax purposes, Green UK will be entitled to deduct development costs and operating expenses incurred wholly and necessarily for the purposes of its trade (such as on staff, IT, advertising, insurance, venue and speakers).

ECI will be able to extract profits from Green UK via dividends or management charges. Dividends are not subject to withholding tax but Green UK would not obtain a corporation tax deduction (because dividends are paid out of taxed profits). Management charges are deductible if at an arm's length rate. The route adopted for profit extraction may have an impact on ECI's US tax position and as stated above this should be reviewed in the US.

The Dublin conferences may create a tax presence in the Republic of Ireland, depending on whether profits arising are attributable to a permanent establishment located there. Advice should be sought from our Dublin office.

For VAT purposes, the conferences involve a package comprising lectures, conference pack and refreshments. We consider this must be treated as a single supply whose predominant element is an educational event. The admission to such an event is treated as a supply of services made where the event takes place. It follows that, for conferences held in the UK, Green UK must add VAT at 20% to delegate fees regardless of where the delegate is established or resides. Business delegates (and those employed by certain bodies, such as local authorities) may be entitled to reclaim the VAT from HMRC. Accordingly, VAT is unlikely to have an impact on pricing of the conferences.

Conferences held in Dublin will be subject to Irish VAT. Our Dublin office will advise further on Irish VAT registration.

Special VAT rules (the tour operators' margin scheme, known as "TOMS") apply to businesses which buy-in and on-supply without alteration services which are commonly supplied as packages to travellers. These rules are complex and do not allow full deduction of input VAT. Conference packages can be caught by TOMS. We consider, however, that as Green UK will not offer travel or accommodation, TOMS will not apply.

Dividends are outside the scope of VAT. Loans are VAT exempt. Management charges made by ECI to Green UK, however, are consideration for a supply of imported services. This is a business-to-business ("B2B") supply and a tax-shift mechanism (known as the "reverse charge") applies. This is to prevent a distortion of competition. ECI would have no VAT liability but Green UK would be required to self-account for output VAT at 20%. An equal amount of input VAT is deemed to arise (which Green UK could deduct as it is used for its taxable business), resulting in a nil net VAT cost.

<u>Recommendations</u>

Advice should be obtained from our Dublin office regarding the Dublin conferences. In deciding whether to extract Green UK's profits via dividends or management charges, ECI should consider the impact on its US tax position. Green UK should, if possible, avoid offering travel or accommodation to delegates in order to remain outside TOMS.

C: DISTANCE-TEACHING

In principle, the same corporation tax issues will arise for Red UK as for Green UK (described in section B above).

The VAT position, however, is more complex. We note that Red UK's customers will be private individuals studying for the Diploma and that they may be resident in the UK and throughout Europe. Our advice, therefore, is premised on the courses being business-to-customer ("B2C") supplies. Private individuals will be unable to recover input VAT. This could impact on pricing. We have therefore considered the scope for any VAT saving. However, for the reasons given below, we have concluded that such savings will not be available.

The first issue to consider is the nature of supply. In return for the course fee the customer receives a package comprising on-line elements (webinars, interactive sessions, assessments) and a printed manual. We consider the course must be treated as a single supply of services whose predominant element is educational. The supply of education is VAT exempt, but only if supplied by, broadly, a school, university or not-for-profit body – which would not be the case here. Furthermore, an exempt supply is disadvantageous to the supplier since, in principle, input VAT is non-deductible. A separate supply of the manual would a zero-rated supply of goods. However, we understand the courses are all or nothing – the customer cannot choose some elements but not others. The manual is integral to the teaching and therefore part of a single supply. Splitting this (for example, by supplying the manual through a separate company) would fall foul of anti-avoidance legislation and case law.

Unlike the conferences, the courses are not educational events supplied where they take place. Instead, they comprise electronically-supplied services (which the legislation defines to include distance-teaching). Special rules apply for determining their place of supply. Red UK must, therefore, adopt the following treatment for B2C supplies:

1) <u>UK-resident customer</u>: UK VAT at 20%.
2) <u>Customer resident in an EU Member State</u>: VAT charged at the rate applicable in that Member State.
3) <u>Customer resident outside the EU</u>: no VAT.

To avoid the need for multiple VAT registrations throughout the EU, a facilitation procedure (the mini-one-stop-shop, or "MOSS") can be requested for electronically-supplied services. Registration is in one Member State only. A consolidated return is made to account for any VAT chargeable in all other Member States. Red UK will be entitled to recover any UK input VAT in full. There is also a separate procedure allowing Red UK to reclaim any VAT which it incurs in another Member State (although, in practice, this may be unlikely).

The royalty paid to Protecting the Planet is consideration for an imported supply of services. As in the case of management charges made by ECI, the reverse charge applies. However, Red UK will not incur a net VAT cost because input VAT is recoverable.

Recommendations

Red UK should carefully check the VAT status and residence of its customers. If the UK leaves the EU, we recommend using the Irish VAT registration to request MOSS although, of course, a UK VAT registration will also be required.

D: OFFICE BUILDING

Purchase

There are two routes for Green UK to acquire the building. On the figures quoted, Propmax are correct that a share purchase will result in a tax saving (the higher guide price appears to share this saving).

This is a new commercial building and sale of the freehold is automatically liable to VAT at 20%. Although not mentioned in the letter, we would expect Propmax to provide in the contract for VAT to be added on – which they are entitled to do). Green UK would also be liable for SDLT, calculated on the total consideration including VAT. Here, the SDLT would be £169,500. VAT would be deductible, provided Green UK intends to use the building wholly for taxable supplies. The conferences are taxable, but see Letting below.

On a share purchase Green UK would become the owner of all the assets including the building. This could include the benefit of any sub-contractor warranties or guarantees on its construction (which might otherwise have to be novated or assigned to Green UK). A share sale is VAT exempt. SDLT is not chargeable and Green UK would be liable only for Stamp Duty at 0.5% (£15,500). It follows, therefore, that the share purchase is the cheaper route. However, great care must be exercised when buying a company, in case of latent liabilities. The costs of carrying out due diligence and of obtaining suitable warranties and indemnities from the seller must be weighed against the apparent saving of SDLT. This needs to be investigated further before a decision is made. Green UK might also incur a higher tax charge on a subsequent disposal of the building if it purchases the shares rather than the freehold and has to sell the building rather than the shares. This is because the base cost in the company will reflect the construction costs, which may well be far lower than the current value with the result that the gain is greater.

The capital cost of purchasing the freehold (or the shares) and SDLT/stamp duty are not allowable deductions for corporation tax.

Capital allowances may be claimed on certain plant and machinery and on fixtures (such as partitioning) which are integral to the building.

Letting

Initially, it is proposed to let surplus space to a third party. Property letting is, in principle, VAT exempt. However, Green UK should opt to tax the building. This has the effect that VAT becomes chargeable on lettings and subsequent sale and, importantly, Green UK would then be entitled to deduct input VAT in full. SDLT is chargeable on lease premiums and the present value of certain rents. If Red UK subsequently occupies part of the building, it should recover VAT charged on its rent.

Property income is treated as a separate trade of a property letting business with its own deduction rules and any profits are chargeable to corporation tax.

Recommendations

Based on the figures quoted, purchasing the shares will result in a tax saving of around £50,000 but this must be weighed against the risks. In any event, Green UK should immediately notify HMRC of its option to tax the building (as explained above).

E: GROUP RELIEFS

Green UK and Red UK are under the common control of ECI. They comprise a group for corporation tax purposes. In principle, each company could carry forward trading losses to set against its profits in future years. Alternatively, group relief could be claimed. This entitles a group member to set-off its losses against the profits of other members of the group in a current year.

Green UK and Red UK also comprise a group for SDLT purposes. Thus, Red UK could claim SDLT group relief on lease premiums or rents paid to Green UK.

The companies would also be eligible to apply to HMRC for VAT grouping. Advantages include: supplies between group members are disregarded; a single consolidated VAT return is made. Input VAT, however, is recoverable only to the extent supplies entitling deduction are made to persons outside the group. Therefore, any letting of office space to Red UK would be disregarded. Green UK's input VAT recovery would be unaffected, provided the building is wholly used by both companies in making taxable supplies to persons outside the group. This would be the case assuming it is used for the conference and distance-teaching businesses. Each member of a VAT group registration is jointly and severally liable for any VAT due which may be an issue given the desire to ring-fence the distance-teaching trade.

Fiscatorum LLP
7 November 2019

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:

20%	Identifying company residence and exposure to corporation tax and VAT; in particular, the relative advantages of a subsidiary over a branch structure. Identifying tax treatment of transactions between head office/parent and branch/subsidiary; and tax issues relating to start-up of a UK business.
25%	Identifying the tax treatment of the conference trade, including special place of supply rules and possible exposure to TOMS; and, in the case of Dublin conferences, the need for Irish tax advice.
30%	Identifying tax issues for the distance-teaching trade and the greater complexity of the VAT position: single composite supply (for which exemption, or supply-splitting, will not be available); likely characterisation as an “electronically-supplied” service; B2C rule and availability of MOSS facilitation.
20%	Comparing tax treatment of property sale with acquisition of shares in the property company, highlighting potential problems with the latter. Identifying tax treatment of letting income, capital allowances and the effect of the option to tax.
5%	Identifying availability and effect of group relief, SDLT grouping and VAT grouping.

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. Thus, supposing a candidate scores 3, 3, 2, 4 and 2 respectively on the above topics, this will equate to weighted scores of 0.6, 0.75, 0.6, 0.8 and 0.1. The total of these scores is 2.85. 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:

25%	Recommending early incorporation of a UK subsidiary to carry on the conference trade (funded by a combination of debt and equity, with profits extracted through dividends and management charges, explaining the tax treatment of each). Recommending VAT registration as an intending trader. Recommending a similar structure for distance-teaching.
20%	Recommending how to avoid TOMS. Recommending separate treatment of Dublin conferences and need for advice on Irish tax position.
30%	Recommending treating distance-teaching as a single composite supply; careful monitoring of customer status and belonging; and use of MOSS.
25%	Recommending freehold purchase route, option to tax and SDLT/VAT grouping.

The final grade will be determined for this skill in the same way as for Identification and Application. Candidates will be given credit for reasonable alternative structures supported by valid arguments.