Application and Professional Skills

Chartered Institute of Taxation
Excellence in Taxation

VAT and Other Indirect Taxes

(Ensure this number matches your candidate number on your desk label and on your candidate attendance form)

BIR	Centre Code
0 9 0 5 2 0 1 9	Date of Examination

☐ Tick box if you have answered in accordance with Scots Law

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Instructions

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DRAFT REPORT FOR KURE LEISURE PLC

From: Charles Brown

To: Tim Woodstock

Date: 09 May 2019

Subject: Kure Leisure Plc - Acquisition of Target Ltd

As requested I have pulled together a report on the acquisition of Target Ltd, and made considerations for the client to consider, regarding an asset or share acquisition

Executive Summary

- From the considerations raised I would recommend a share sale ~~pay~~ from a cost analysis perspective, as under an asset sale you will pay considerably more SDLT, will have to make a s.44 adjustment and will not get immediate tax relief, only when you sell. Also under a share sale you will be able to use the losses from Target Ltd which is a substantial amount at £1.8 million.
- Under a share sale, I highly recommend including indemnities and warranties in the contract to protect yourselves from the errors and liabilities you have found in the due diligence review as well as any that may be found further down the line.
- It may also be worth considering whether a hive down could be an option and performing a cost analysis.

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- Alternatively you could also barter down the price of the share sale for the potential VAT that may need to be paid to HMRC. I estimate it to be around £400,000 but penalties and interest may also be due on this amount.

- ~~Ple~~ You will also need to update your partial exemption special method on the acquisition of a new business, therefore I would make them aware as soon as possible so if a new method needs to be agreed it can be in place from the offset.

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- Also as a side note looking at your balance sheet it looks as though you may have potential liquidity issues. Therefore before the acquisition you may want to look into this and consider restructuring ~~or~~, issuing rights issues, or converting short term loans to long term, so you do not come into any financial difficulties.

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Updating Target's facilities

REBRANDING

The costs of the rebranding will be a capital cost and cannot be deducted from your corporation tax liability.*

Any VAT incurred on these costs will be fully recoverable presuming they relate fully to the taxable supply of the restaurants and bars.

* This is because the costs are not for repair but to update the facilities.

SWIMMING POOL

The replacement of the swimming pool is also a capital cost but ~~can~~ is a ~~an~~ qualifying asset for capital allowances. Therefore you will receive relief at 18% for the costs incurred, £800,000.

Any VAT incurred will also be fully recoverable assuming they relate to a fully taxable supply, otherwise ~~it~~ subject to the partial recovery rate.

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1.0 SHARE SALE

1.1 - VAT Rate

Under a share sale, the transaction will be VAT exempt and no VAT will be due.

1.2 - SDLT (Stamp duty land tax)

The stamp duty land tax rate is a lot lower for a share sale at 0.5%. In appendix 1, I have calculated the tax to be £35,250 which is considerably lower than the asset sale.

1.3 - Input tax

Any input tax incurred on the share acquisition is to be treated as residual and will be recoverable subject to your normal partial exemption recovery rate

1.4 - Partial Exemption Special method

As you operate a special method you will need to make HMRC aware from the outset, and how this may affect your special method and recovery rates. You will need to agree in writing a new method, and may have to use the special method override whilst this is agreed.

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1.5 - History

A big issue with the share sale is you will inherit the history and liabilities for Target Ltd, and from the due diligence checks carried out they have potential liabilities and penalties. I have gone into further detail in part 2.

To protect yourself you could include indemnities, to protect from any potential liabilities, and warranties, which will allow you to claim damages if they are breached.

These indemnities and warranties however are only as good as the people who give them, and as the company is owned by individual shareholders may not withstand.

1.6 - Losses carried forward

A positive about the share sale is the losses can be carried forward and offset against any future corporation tax liabilities. As the losses are rather substantial at £1.8m, this may be attractive.

If you do want to use the losses, please be aware if there is a major change in nature or conduct of trade, then the losses cannot be used and will be lost.

As the losses are extremely large this is a good reason to do a share sale.

2.0 DUE DILIGENCE

From the due diligence report it appears Target Ltd may have some potential errors and liabilities which under a share sale will be transferred to yourselves. I have looked into the tax issues in further detail below.

2.1 Removable contents - new static caravans

As the VAT has been underdeclared, due to only calculating the amount to pay on the previous figures, the purchase price and not the sale price which has a 45% mark up. In appendix 2 I have calculated the underdeclared output tax to be £57,600. This could also be liable to potential penalties and interest.

2.2 Sale of second hand caravans

As the basis of valuation differs to the standard method agreed, I would check with Target Ltd to see if this has been formally agreed with HMRC and is in writing. If not I think the standard method should have been used and therefore an underpayment of VAT ~~may~~ In appendix 2 I have calculated the VAT to be paid at £52,700 using the standard method agreed. Therefore an underpayment of £42,160 ~~for~~ output tax, which also could be subject to penalties & interest.

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2.2 continued

The margin scheme for caravans can be used for sale on second hand caravans which are not zero rated.

If the caravan is zero rated the margin scheme can still be used for the removable contents.

As the caravans were acquired from a non-VAT registered person, no VAT will have been charged on sale to Target Ltd and can therefore has been included in the margin scheme correctly.

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2.3 Reduced rate - provision of fuel, power and water.

Even though the pitches are metred because ~~you~~ they are charging a fixed rate the supply cannot be charged at the reduced and zero rate but must follow the liability of the pitch rental.

As the pitch has an occupancy restriction the pitch can only be exempt if the site is not advertised or held out for holiday / leisure use, and the pitch is intended to be used as the occupant's principal private residence.

I have assumed that both of these conditions aren't met and as such the standard rate of VAT applies.

I have calculated the VAT due under this approach in appendix 2 and again an underpayment of output tax has been made, £134,550. For further information Colaingrove VAT case.

2.4. Grant of 10 year licenses

As above the occupation restriction has the conditions, described above, therefore if Target Ltd do not meet them conditions then the pitches should be standard rated, therefore a potential £84,000 output tax could be due.

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2.5 Corporation Tax

If the expenditure is classed as capital there will be no deduction available and ~~the~~ Target Ltd will have underpaid corporation tax by £85500 (450,000 × 19%).

However as a capital item, capital allowances can be utilised and AIA may have been available to use at around £200,000, which would reduce the underpayment and will provide some tax relief.

2.6 Summary

As Target Ltd have a lot of potential errors and liabilities which Kure Leisure will inherit under a share sale, this could potentially be a deterer for the share sale.

There are possible options such as asking Target Ltd to declare all issues to HMRC and pay any liabilities before the sale, and then include indemnities and warranties to cover for any other issues which may arise.

Alternatively a hive down of Target Ltd may be possible where they hive down the shares into a new company, and the new company with no history or liabilities is sold. However there are potential exit charges to consider with this that will

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need to be looked at in more detail.

You may also want to consider asking to reduce the price of the share sale based on the issues you have found.

You might also want to consider that if values have been calculated incorrectly this might affect their partial exemption calculation.

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3.0 ASSET SALE

3.1 Transfer of going concern (TOGC)

As the asset sale will be a TOGC, the transfer will be outside the scope of VAT. As the target company had not opted to tax their property, you do not need to make an option to tax. As you are already probably aware you must meet the following conditions for a TOGC to apply:

- the assets are to be used by the business with the intention of carrying on the same kind of business
- there must not be a series of immediately consecutive transfers

as well as some others which from the information provided you will meet.

3.2 Stamp duty land tax

As you are acquiring land and buildings an SDLT charge will apply, using the non-residential rates. I have calculated this to be roughly £327,000 which is considerably more than a share sale.

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3.3 Input Tax Recovery.

Any input tax incurred during the TOGC, for professional fees, for example will be subject to recovery dependent on Whether the trade is taxable under UBAF principles.

As the income for Target Ltd has both taxable and exempt elements (the license fees for residential park homes), then the input recovery will be based on the partial exemption recovery rate.

3.4 CGS scheme

Under a TOGC the CGS scheme and adjustments made by Target Ltd will be inherited.

As capital items, the land / freehold interests, are being transferred as part of the TOGC, then you, as ther new owner, assume responsibility for any adjustments of input tax required under the scheme for the remainder of the adjustment period. You should therefore confirm with Target Ltd if any assets are covered by the scheme and details of the adjustments previously made.

If you change your intention of how you will use the goods or actually use them for a completely different purpose, the 'clawback' or 'payback' provisions may apply. We can look into this in further detail if and when required.

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3.4 S.44 adjustment

As you are a partially exempt business acquiring a business through a TOGC, you may be liable to a S.44 adjustment. This is an adjustment for any chargeable assets that are transferred as part of the TOGC, you must account for the self supply. ~~In appendix 3, I have calculated~~

This adjustment does not apply to assets which were held by Target Ltd 3 years prior to the transfer or any assets which are capital items within the capital goods scheme.

The value of the self supply will be at open market value of the chargeable assets.

Therefore this will be an additional cost to the asset transfer as recovery will be subject to your partial exemption recovery rate.

As Target Ltd are also partially exempt you can also reduce the VAT chargeable by the amount they will not have recovered when purchasing the assets (their partial exemption recovery rate).

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3.5 Cost base

The cost base will be transferred over to you, based on Target Ltd's capital gains tax calculation, and therefore there will be no immediate tax relief.

3.6 Goodwill

As the Goodwill purchased is an intangible fixed asset, there is no amortisation relief available.

3.7 S.198 Election - commercial property

Under an asset sale the assets will be transferred across and the buyer and seller can make an election under S.198 to set the cost base of the asset. As a buyer you will want this to be the market value or higher.

If you cannot agree a value then it will go to the tribunal to decide.

3.8 Capital allowances

You will get capital allowances on any fixtures, fittings, integral features etc under the general pool and the special rate pool.

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3.9 History

Unlike the share sale no history will be transferred to yourselves as the trade will have cessated and begun again. ~~This is a huge~~ This is a huge benefit as from the due diligence work carried out, there are a few potential issues.

3.95 Assets

When you acquire the assets you can also cherrypick which parts of the business, which assets you would like.

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Appendix 1

STAMP DUTY LAND TAX (SDLT)

Share sale

SDLT is at 0.5% for share sale

£7,050,000 @ 0.5% = £35,250

Asset sale

£6,750,000 Non-residential property.

150,000 @ 0% = 0

100,000 @ 2% = £2,000

6,500,000 @ 5% = £325,000

£327,000

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Appendix 2 - Due diligence

Removeable contents - new static caravans

Caravans brought £16,000,000

VAT - relating to

removable contents £128,000

Caravans sold @ 45 % mark up £23,200,000

VAT relating to removeable contents

(23.2 million x 4 % x 20 %) £185,600

Underdeclared output VAT £57,600

2.2 Sale of second hand caravans

Based on 10% - standard method

Direct from manufacturer £3,000,000

VAT payable £50,000 [3,000,000 x 10% ÷ 6]

Used caravan £162,000 [162,000 x 10% ÷ 6]

VAT payable £2,700

Actual VAT paid £10,540

VAT should have been paid : £52,700

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2.3 Reduced rate - provision of fuel, power & water

~~40~~ 39 weeks occupied

£7 charge for fuel, power & water

750 licences -

750 x 7 = £5250 x 39 weeks = £204,750

4 years = £819,000

@ 20% = £163,800

Underpayment = £134,550