The Chartered Institute of Taxation

Application and Professional Skills

Human Capital Taxes

November 2021

Suggested solution

Report to Sara Qureshi, Head of Tax, MGB Style Ltd

Introduction & Scope

This report is provided to Sara Qureshi in response to her letter dated 29 October 2021. The contents are based on the information in that letter and the accompanying attachments.

This report reviews two proposed methods of purchasing the business of Ordinateur Ltd:

1. MGB Style Ltd to acquire the shares of Ordinateur Ltd
2. MGB Style Ltd to acquire the trade and assets of Ordinateur Ltd

Our advice below is provided under the terms and conditions of our engagement letter with MGB Style Ltd under which we provide UK tax advice. Our report is prepared for MGB Style Ltd and no third party may rely on it without our consent.

The report is based on current legislation and will not be updated to reflect future legislative changes unless requested.

Executive Summary

There is a choice between acquiring the shares of Ordinateur Ltd or acquiring their trade and assets.

We recommend structuring this as a trade and asset purchase for the following reasons;

- Under a trade and asset purchase you would be able to take only the parts of the business that you require (the employees, the building and the plant and machinery).

- You would not take on the administration of an additional corporate entity, with the associated accounts and tax returns.

- Buying the plant and machinery independently would also allow some corporation tax deductibility of the amounts being spent on the acquisition. At the current rate of corporation tax we calculate that this is worth £40,850 (APPENDIX A).

- You would also not have to take on responsibility for issues that may have arisen in the company's past. Ordinateur Ltd has potential tax issues in both the UK and France. We have identified underpayments in the UK of £2,251 plus penalties for not filing the appropriate employment related share scheme documentation. This identified amount of UK tax due is low. However, we believe there may also be an undisclosed French permanent establishment, a need to pay French social security on the employment income of the principal developer and additional employment tax obligations in relation to the share scheme. The internal administration and professional fees required to rectify the past will add to any potential cost.

The downsides of structuring this as a trade and asset purchase are:

- As there is a building involved the stamp duty land tax payable under this method of acquisition is higher than the stamp duty payable on a shares acquisition by £22,000.
- The legal arrangements on the transfer are more complicated requiring discussion with customers, suppliers and the employees.

In the context of this acquisition, we believe these downsides are outweighed by the benefits.

If, for other reasons, you decide to pursue a share purchase, we recommend that an indemnity is obtained from Ordinateur S.A. against any possible underpaid taxes and the costs of rectification. Advice should be obtained from a qualified French tax adviser.

In either case, we recommend that Francois Du Plessis should be persuaded to move his family to the UK. If this is not possible, he should reduce the number of days a week he works in France to mitigate the Permanent Establishment and French social security risks identified in this report.

We also recommend a full status determination assessment is performed in relation to the working arrangements of Brad Flowers to ensure that all requirements of the off payroll working legislation are met.

This report has been split as follows;

A: LEGAL AND PRACTICAL IMPLICATIONS
B: CORPORATION TAX
C: INDIRECT TAXES
D: EMPLOYMENT TAXES

A: Legal and Practical Implications

Proposal A: Purchasing the shares of Ordinateur Ltd

A company is recognised in law as a person separate from its shareholders, directors, or employees.

Ordinateur Ltd will continue to run undisturbed as a business. All existing contractual arrangements will continue automatically. This includes the contract with Brad Flowers, and any contracts they have entered with other customers. Employment contracts with Ordinateur Ltd employees would continue under existing terms and conditions.

You will take on responsibility for any past non-compliance in respect of Ordinateur Ltd's tax affairs. We believe there are some employment tax issues to be considered (see Section B). A thorough due diligence exercise is recommended.

Less administration is required on the purchase as you are simply buying one asset, the shares.

Proposal B: Purchasing the trade and assets of Ordinateur Ltd

If you buy the trade and assets of Ordinateur Ltd you are buying a collection of assets.

Contractual obligations will all need to be assessed and addressed separately. Customer contracts can be transferred over to you but will require the consent of the customers.

You are not obliged to continue using Brad Flowers. If you do, you should agree a new contract between his company and MGB Style Ltd.

The employment contracts of the Ordinateur Ltd staff would move to MGB Style Ltd under the same terms as now under the TUPE regulations. Employees would be able to claim unfair dismissal if you insist on a change in their employment terms in connection with the transfer. We recommend you take appropriate employment law advice.

While there is more administration required to address the above, the benefit of buying the assets is that you do not take on responsibility for any liabilities related to Ordinateur Ltd's past. For example, you will not be considered responsible for any of Ordinateur Ltd's tax history.

Conclusion

Buying the trade and assets is preferable as it protects you from liabilities related to past behaviour of Ordinateur Ltd and gives you more choice over which contractual relationships you wish to continue.

B: Corporation Tax

Corporation Tax Deductibility of Acquisition Costs

Proposal A: Purchasing the shares of Ordinateur Ltd

The purchase of shares is a capital investment and is not deductible for corporation tax.

If you were to sell Ordinateur Ltd, this amount would be deductible on calculating the capital gain. However, assuming tax legislation remains as at present, if you have held the Ordinateur Ltd shares for at least 12 months and the company is still a trading company at the time of the sale, any gain can be expected to be exempt under the Substantial Shareholding Exemption in any case.

Capital allowances on qualifying assets would continue to be available within Ordinateur Ltd after purchase.

Proposal B: Purchasing the trade and assets of Ordinateur Ltd

No corporation tax deduction is available for the amortisation of the purchased goodwill or the freehold building.

Capital allowances would be available for MGB Style Ltd on the following assets

- Company cars
- Employee laptops and other office equipment
- Qualifying fixtures and fittings in the freehold property. An election should be made to set the proportion of the purchase price that relates to these.

Corporation Tax following acquisition

Proposal A: Purchasing the shares of Ordinateur Ltd

There will be two separate companies in a wholly controlled group. Each company will need to file a corporation tax return resulting in an increase in administration.

Any dividends paid by Ordinateur Ltd will not be taxable income for MGB Style.

The group would potentially be subject to transfer pricing rules on the IT services Ordinateur Ltd will provide to MGB Style as MGB Style would control Ordinateur Ltd. However, given the size of the companies we would expect the group to fall within the exemption for small and medium sized companies.

Proposal B: Purchasing the trade and assets of Ordinateur Ltd

For MGB Style Ltd the corporation tax position will not change very much with only one corporation tax return required.

French PE Risk

Francois is spending approximately 40% of his time working in France.

The French Tax Authorities could contend that this has created a Permanent Establishment of his employing company. This would result in his employer being required to file French corporation tax returns to pay tax on the proportion of the employer's profits attributable to the permanent establishment. Although double tax relief may be available in the UK for any French taxes, the increased administration and professional fees required to manage the permanent establishment can be considerable.

Proposal A: Purchasing the shares of Ordinateur Ltd

This option has the advantage that the risk of creating a French Permanent Establishment is limited to Ordinateur Ltd's business only. As a result, none of the profits of MGB Style Ltd would be potentially exposed to French corporation tax.

However, it has the disadvantage that you would be taking on the history of potential non-compliance in France that already potentially exists before your purchase.

Proposal B: Purchasing the trade and assets of Ordinateur Ltd

This option would have the advantage that MGB Style Ltd would have no responsibility for any past risks that exist. This gives you the opportunity to address this issue now and seek to stop the principal developer spending so much time working in France.

However, if the French working carries on in a similar pattern after Francois becomes an MGB Style employee, MGB Style Ltd may create a PE in France, depending on the nature of the work he undertakes.

<u>Conclusions – Corporation Tax</u>

Buying the trade and assets of Ordinateur Ltd is the more advantageous route.

It would allow some corporation tax deductibility of the amounts being spent on the acquisition.

It would avoid duplication of corporation tax return administration and eliminate any future transfer pricing considerations.

However, as discussed above, MGB Style Ltd could be exposed to the risk of having a PE in France in the future.

<u>**C: Indirect Taxes**</u>

<u>Stamp Duty and Stamp Duty Land Tax</u>

Proposal A: Purchasing the shares of Ordinateur Ltd

Stamp duty will be charged at 0.5% on the price paid for the shares. At a purchase price of £1,000,000 this will come to £5,000.

This is payable by MGB Style Ltd within 30 days of completion of the acquisition.

It is not deductible for corporation tax purposes as this is capital expenditure. It will be added to the base cost of the shares for the calculation of any future capital gain.

Proposal B: Purchasing the trade and assets of Ordinateur Ltd

SDLT of £27,000 will be charged on the transfer of the freehold property (See appendix B).

This is payable by MGB Style Ltd within 14 days of completion of the acquisition

SDLT is also not deductible for corporation tax and will be added to the base cost of the freehold property.

VAT

Proposal A: Purchasing the shares of Ordinateur Ltd

No VAT arises on acquisition of shares which are an exempt supply for VAT.

VAT would be due on supplies between the two companies. MGB Style could form a VAT group with Ordinateur Ltd as it will control them. If this is done Ordinateur Ltd would not have to charge VAT on future services provided to MGB Style. Additionally, only one VAT return would be required for the whole group, though a new VAT number would be issued to the group.

MGB Style Ltd will take responsibility for the VAT history of Ordinateur Ltd. No issues were raised in the due diligence, but we recommend that an indemnity is sought to cover the pre-acquisition period.

Proposal B: Purchasing the trade and assets of Ordinateur Ltd

The acquisition is outside the scope of VAT if it is considered as a transfer of a going concern (TOGC) where a business is being purchased rather than a bundle of independent assets. A condition for TOGC treatment is the intention to continue the same kind of business. As the Ordinateur Ltd business acquired will continue to trade with other customers after the acquisition this purchase should be considered a TOGC.

It is not known why Ordinateur Ltd exercised the option to tax previously as there are no indications that the property has been let out in the past. However, as Ordinateur Ltd has opted to tax the building then this will only be considered part of the TOGC for VAT purposes if MGB Style Ltd also does so. Whilst there is no obligation on MGB Style to also exercise the option to tax, if you choose not to standard rated VAT at 20% will be applied on the freehold property, as it will fall outside of the TOGC.

All the VAT is recoverable for MGB Style Ltd, however there will be a time lag between paying the VAT on the acquisition and reclaiming it on your VAT returns. As the freehold property costs more than £250k it will be within the capital goods scheme. This should not be a problem though provided MGB Style continues to make wholly taxable supplies.

Additionally, if the freehold property is subject to VAT this will increase the SDLT payable on the acquisition as SDLT is calculated on the VAT inclusive price.

However, if you do exercise the option to tax prior to the purchase, the whole transaction would be a TOGC, and you would avoid the additional SDLT charge. You should recognise however that if you sell or let the property in the 20 years following acquisition VAT would need to be charged. Provided you do not plan to do this the option to tax would have no practical impact.

Conclusions – Indirect Taxes

It would be preferable to acquire the shares of Ordinateur Ltd as stamp duty on the shares is £22,000 less than the SDLT on the free hold property.

D: Employment Taxes

Payroll Obligations – French Principal Developer

Given his family residence in France and the amount of time spent in each country we expect that Francois Du Plessis is likely to be tax resident in both France and the UK for domestic purposes. Under treaty tie breaker rules he would be considered French resident for the purposes of interpreting the DTA and giving double tax relief as his family is located in France. His position should be reviewed in detail should the deal go ahead.

If this is the case, the UK will only have the right to tax UK workdays.

More than 25% of his time is spent working in France. Since France is where he and his family live, this will be his habitual abode. Under EU multi state worker social security rules both employer and employee social security are therefore payable in France and not the UK.

Currently UK PAYE income tax and NIC is being paid over on 100% of employment income. No French payroll taxes are being applied. There may be a legal obligation to do so and we would recommend you confirm the position in France.

Proposal A: Purchasing the shares of Ordinateur Ltd

MGB Style would take on the history of Ordinateur Ltd and will need to rectify the past position with the French authorities and operate payroll withholding correctly in the future.

Actions needed;

- A 690 application to the UK authorities to limit UK payroll withholding to the proportion of days worked in the UK
- An A1 certificate of social security coverage from the French authorities.
- The reclaim of any UK NIC overpaid.

We recommend you seek French tax advice on potential payroll obligations. We also recommend that you seek an indemnity from seller to cover the cost of settling past liabilities.

We also recommend that you consider whether it would be appropriate to persuade him to move his family to the UK to avoid these issues in the future.

Proposal B: Purchasing the trade and assets of Ordinateur Ltd

MGB Style will be the new employer of Francois Du Plessis and needs to set up new arrangements as described above. You will be doing this afresh with no history of non-compliance.

Share scheme payroll and reporting obligations

Payroll obligations

Although the option scheme has been operated by the French parent company, Ordinateur Ltd should have operated payroll withholding at the point of exercise, paid employer NIC and undertaken share scheme reporting. Shares are Readily Convertible Assets as the French parent company is listed on the French stock exchange.

We estimate that there is underpaid payroll and NIC withholding of £ 2,251 (Appendix C) on the June 2021 share vest and exercise. No taxes are due at the point of the grant of an option, however there will be further withholding required when the options granted on 2 June 2021 are exercised.

For most of the employees UK PAYE and NIC would be due on 100% of the share gain realised on the exercise of their options.

For Francois Du Plessis, as he has a significant proportion of his time working outside of the UK, Ordinateur Ltd could have operated best estimate PAYE withholding on 60% of the share gain. Class 1 NIC is due on all or none of the gain depending on what social security system he was covered by during the vesting period. For our calculations we have assumed this is France.

As we are still within the 2021/22 tax year the UK payroll withholding can be rectified in the next payroll submission. Ordinateur Ltd will need to reclaim the employee NIC and income tax from the employees within 90 days of the end of the tax year, i.e. 5 July 2022

Share scheme reporting

Reporting should have started in the first year there was a reportable event. In this case the grant of options in June 2020 created the need to register the scheme and file a report for 2020/21 by 6 July 2021.

An annual return should have been submitted on 6 July each year. The 2020/21 report is currently more than 3 months but less than 6 months late therefore automatic penalties of £400 are due. A further £300 will be levied if it is not filed by 6 January 2022.

Ordinateur Ltd should register the scheme with HMRC using the ERS online service and file a return as soon as possible.

Corporate Tax Deduction

A corporation tax deduction is available for Ordinateur Ltd at the point of option exercise. The amount of the deduction is the market value of the shares on acquisition less any amount paid to acquire the shares. In this case the deduction will total £4,500. The full deduction is available for the options exercised by Francois Du Plessis as he is a UK employee. This is unaffected by his personal tax position.

Proposal A: Purchasing the shares of Ordinateur Ltd

MGB Style takes on the history of the company therefore will need to rectify the past position

You must ensure PAYE is operated correctly in respect of the vest due to take place on acquisition.

We recommend that you get an indemnity from the seller to cover the financial cost of settling past liabilities

Proposal B: Purchasing the trade and assets of Ordinateur Ltd

The past lack of withholding and the payroll withholding on the accelerated vest remain Ordinateur Ltd's responsibility. However, as the individuals will be MGB Style Ltd's employees we recommend asking the vendors to guarantee that they will rectify these issues.

<u>Ltd Company Contractor</u>

As the off payroll working regulations have now been extended to the private sector it is important to consider whether they should be applied to the arrangement between Brad Flowers and Ordinateur Ltd. He appears to be providing his personal services to Ordinateur Ltd and operates through a company which he owns.

At present Ordinateur Ltd is a small company for the purposes of these regulations and does not have to take any of the above actions.

Proposal A: Purchasing the shares of Ordinateur Ltd

Even though Ordinateur Ltd will still be a small company it will now have a parent which is not small and therefore will be within the scope of the off payroll working legislation. Therefore, Ordinateur Ltd would be required to assess their relationship and issue Brad with a "Status Determination Statement" confirming whether or not, in their reasonable opinion, the relationship would have been that of employer and employee had the contract been directly between Ordinateur Ltd and Brad. If it is considered that Brad would be an employee if he contracted directly with Ordinateur Ltd then would be required to withhold PAYE from the VAT exclusive element of any fees paid.

Proposal B: Purchasing the trade and assets of Ordinateur Ltd

As a medium sized company MGB Style Ltd is already within the scope of these rules. You should follow your normal processes for engaging a Ltd company contractor.

<u>Conclusions – Employment Taxes</u>

Buying the trade and assets of Ordinateur Ltd would be preferable as MGB Style Ltd would not be taking on any past employment tax non-compliance by Ordinateur Ltd. MGB Style Ltd can start afresh correctly.

Appendix A: Corporation Tax Relief on Acquisition

	£	
Company Cars	150,000	
Employee laptops	15,000	
Other office equipment	50,000	
	215,000	
Corporation Tax Relief @ 19%		**£40,850**

Appendix B: SDLT on the transfer of the freehold property

Consideration £750,000	SDLT rate	SDLT £
First £150,000	0%	0
Next £100,000	2%	2,000
Remaining £500,000	5%	25,000
Total		**27,000**

Appendix C: PAYE failure on June 2021 share vest

UK resident employees (4 individuals)

	£
MV @ vest	1,000
Less option price	(100)
Option gain	900
Income Tax @ 40%	360
Employee NIC @ 2%	18
Employer NIC @ 13.8%	124
Total per individual	502
For all 4 individuals	2,008

Principal Developer (assuming 60% UK taxable and not subject to NIC)

	£
MV @ vest	1,000
Less option price	(100)
Option gain	900
Option gain x 60%	540
Income Tax @ 45%	243
Employee NIC @ 2%	0
Employer NIC @ 13.8%	0
Total per individual	243

Total = £2,251