A CAPITAL PLAN

THE LATEST RULES ON CORPORATE CAPITAL GAINS REPRESENT A RELAXATION IN THE HMRC APPROACH, SAYS PETER RAYNEY

In 2007, the capital gains rules for companies were identified as needing simplification. After considerable consultation and legislative drafting, the Finance (No.3) Bill 2011 (F(No.3)B 2011) now contains the final results of this exercise.

There are a number of changes to the corporate capital gains group provisions, which broadly apply where companies are 75% owned by a 'group'. However, this article concentrates on the revised degrouping charge rules since they will have a wide impact on corporate disposals. All amendments are introduced by the Finance (No.3) Bill 2011 and will apply when the Bill receives Royal Assent (and may be subject to alteration until they become law).

Unless stated otherwise, all statutory references are to the Taxation of Chargeable Gains Act 1992.

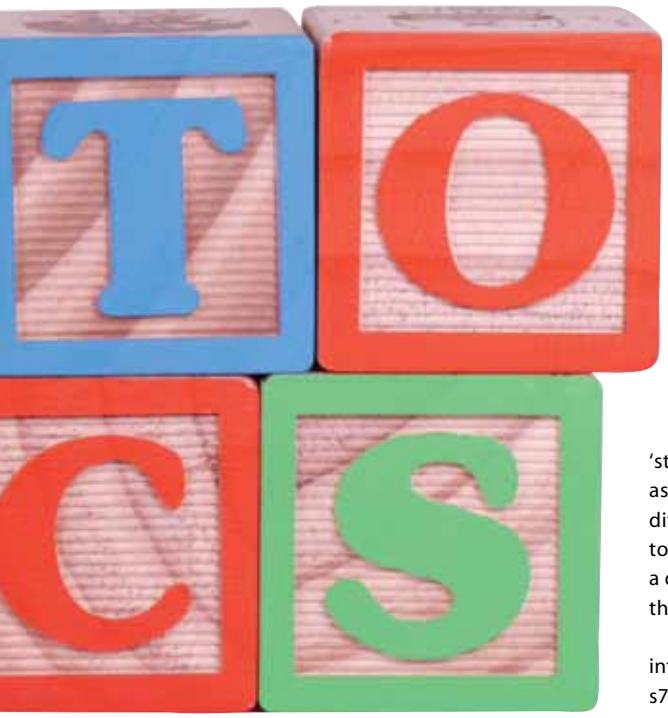
BACKGROUND TO DEGROUPING CHARGES

The degrouping charge rules were first introduced in 1968 to counter the so-called 'envelope trick', which enabled corporate groups to sell assets to third parties without incurring a taxable gain. The 'envelope trick' entailed first transferring an asset into a subsidiary under the 'no gain/no loss' rule (for intra-group transfers) in consideration for shares (or for debt). Since the shares had a base cost equivalent to the base cost of the asset, it was then possible to sell the subsidiary (which held the asset) with little or no capital gain.

The rules relax the impact of the degrouping charges, which should assist corporate disposals

Such planning techniques are now caught by the degrouping charge rules in what is now s179. This is because s179(4) requires a deemed disposal (and re-acquisition) of any asset which is transferred into a subsidiary within six years of it leaving the group (typically via a sale to a third party). This degrouping charge only applies where the relevant asset is still held by the subsidiary when it leaves the group.

While the rationale for the degrouping charge is understandable, it has often caused many problems for corporate groups seeking to sell part of their activities some time after a group restructuring exercise. The mechanical nature of the provisions do not distinguish between 'envelope trick' type cases and commercially motivated transactions. Furthermore, since the introduction of the Substantial Shareholding Exemption (SSE) regime in 2002, shares in a subsidiary can often be sold 'tax-free' under the SSE but that subsidiary could still be exposed to a degrouping tax charge under s179 (see Corporate windfall, April 2011).



NEW DEGROUPING CHARGE PROCEDURE

To deal with these concerns, para 3 (6), Sch 10, F(No.3)B 2011 alters the mechanics of the degrouping tax charge. The actual degrouping gain/loss is still calculated on the same basis as before, ie, the transferee subsidiary is deemed to sell and reacquire the relevant asset at its market value immediately after the previous intra-group transfer.

However, where the transferee company leaves the group due to a sale of its shares (or shares in another group company) – as will typically be the case – then the degrouping gain is added to the consideration received for the disposal of the shares. On the other hand, if the deemed degrouping disposal gives rise to a capital loss, this is added to the base cost of the shares being sold (new s179(3D)).

One very important consequence of these changes is that where the sale of the subsidiary (or other group company) qualifies for the SSE, this will also ensure that the degrouping gain obtains the benefit of the exemption. The interaction between the SSE and revised degrouping rules is illustrated in the boxed example on page 72 (Degrouping charge exempted under SSE rules).

The original method for taxing the degrouping charge continues to apply where a company leaves the group other than as a result of a share disposal by a UK resident company (eg, as a result of a share issue that 'swamps' the existing 75% group connection).

INTANGIBLES NOT INCLUDED

Unfortunately, this change in treatment has not been extended to the corresponding intangibles degrouping charge in s780 of the Corporation Tax Act 2009 (CTA 2009). The intangibles legislation applies to goodwill, intellectual property, and other intangible assets created or acquired (from an unconnected party) by a group after 31 March 2002.

As we move further away from the 1 April 2002 'start date', the existence of intangibles regime assets is now becoming more common. Given the different potential tax treatments, groups will need to carefully identify whether any goodwill, subject to a degrouping charge, falls within the capital gains or the intangibles regimes.

If the degrouping involves a (post-March 2002) intangible asset, there is likely to be a tax charge under s780 CTA 2009 in the subsidiary, even where the selling company obtains SSE on the share sale itself.

ASSOCIATED COMPANIES EXEMPTION

When the degrouping rules were introduced it was decided that no charge should arise in relation to assets that had previously been transferred between group members that left the group together on the same sale transaction. This became known as the 'associated companies' exemption (s179(2)).

For many years, the majority of tax advisers considered that the wording in s179(2) only required the relevant companies to be in a 'sub-group' relationship when they left the group and not necessarily at any other time.

HMRC DISAGREEMENT

HM Revenue & Customs did not accept this interpretation, contending that s179(2) contained a further requirement for the two companies to be in a 'sub-group' relationship at the time of the original intra-group transfer of the relevant asset.

This 'disagreement' was finally tested in *Johnston Publishing (North) Ltd v HMRC [2008]* England and Wales Court of Appeal Civ 858, when the Court preferred HMRC's view. However, the case did not clarify some of the other uncertainties inherent in the application of this exemption.

The F(No.3)B 2011 now gives clarity about the relevant conditions that must be met to qualify for the associated companies' exemption. The new s179(2) requires the transferor and transferee companies to be in a 'sub-group' relationship throughout the period starting from the date of the intra-group transfer and ending immediately after they leave the group. For these purposes, a 'sub-group' will exist where either:

- both companies are 75% subsidiaries of another group company (condition A); or
- one of the companies is a 75% subsidiary of the other (condition B).

The same rules will also apply for the intangibles 'associated companies' exemption (s783 CTA 2009).

SPECIAL RULES FOR PRE-SALE HIVE-DOWNS

A very helpful new rule deals with pre-sale hive-downs, which typically involve the transfer of a trade into a newly-formed subsidiary of the transferor followed by its onward sale. In such cases, the conditions for SSE are unlikely to be met.

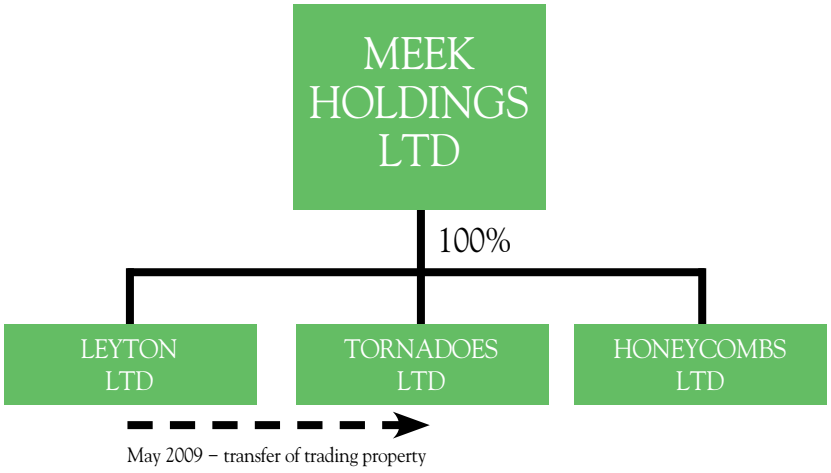
Although this may not necessarily be a material concern for the disposal of the shares in the 'new' subsidiary (since they will often have little if any gain), it would mean that the benefit of the revised degrouping charge rules could not be accessed.

Special provisions enable the beneficial SSE to be applied to exempt the potential degrouping charge in such cases. Under a (new) para 15A, Sch 7AC, the seller (transferor) company is deemed to satisfy the minimum 12 month 'substantial shareholding' period for SSE while the 'hived-down' assets were used for trading purposes by the group. Furthermore, the new subsidiary is deemed to have been a trading company for the minimum 12 month 'SSE' period before the sale.

These rules will also assist groups that carry on their trades on a divisionalised basis. They will now be able to hive-down a trading division into a new subsidiary which can then be sold with the benefit of SSE (which will also prevent tax arising on the potential degrouping charge). Once again, there is no equivalent relieving provision for the intangible degrouping charge (for intangibles acquired/created since April 2002).

Overall, the F(No.3)B 2011 provides some helpful relaxations to the impact of the degrouping charges, which should assist many corporate disposals. HMRC is to be congratulated for taking on board many of the concerns and issues that were raised during the consultation process.

DEGROUPING CHARGE EXEMPTED UNDER SSE RULES



Meek Holdings Ltd acts as the parent company of a music publications, artist management and concert promotions group. The current corporate structure has remained the same for many years and is summarised above.

Meek Holdings Ltd is planning to sell its 100% shareholding in Tornadoes Ltd for £2.5m. The current 'indexed' base cost of the shares is £450,000.

Tornadoes Ltd had acquired its current office premises from Leyton Ltd in May 2009 at its then market value of £1.2m, although for tax purposes it was transferred on a 'no gain/no loss' basis under s171. These office premises had been purchased by Leyton Ltd in July 1991 for £500,000.

Assuming the sale of Tornadoes Ltd takes place in (say) September 2011, the gain on the sale of the shares should be exempt under the SSE rules. As a result of the (proposed) new s179(3A) there should be no tax charge on the degrouping gain in respect of its office premises since it is added to the consideration for the 'exempt' Tornadoes Ltd share sale.

THE RELEVANT CALCULATIONS ARE:

Sale of 100% holding in Tornadoes Ltd	**£'000**
Share sale	2,500
Degrouping gain (see below)	405
Total sale consideration	2,905
Less: Indexed base cost	(450)
Capital gain = exempt under SSE	2,455
Degrouping charge	
Deemed MV (May 2009) consideration	1,200
Less: Base cost	(500)
Indexation (£500,000 x 0.59)	(295)
Capital gain	405

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