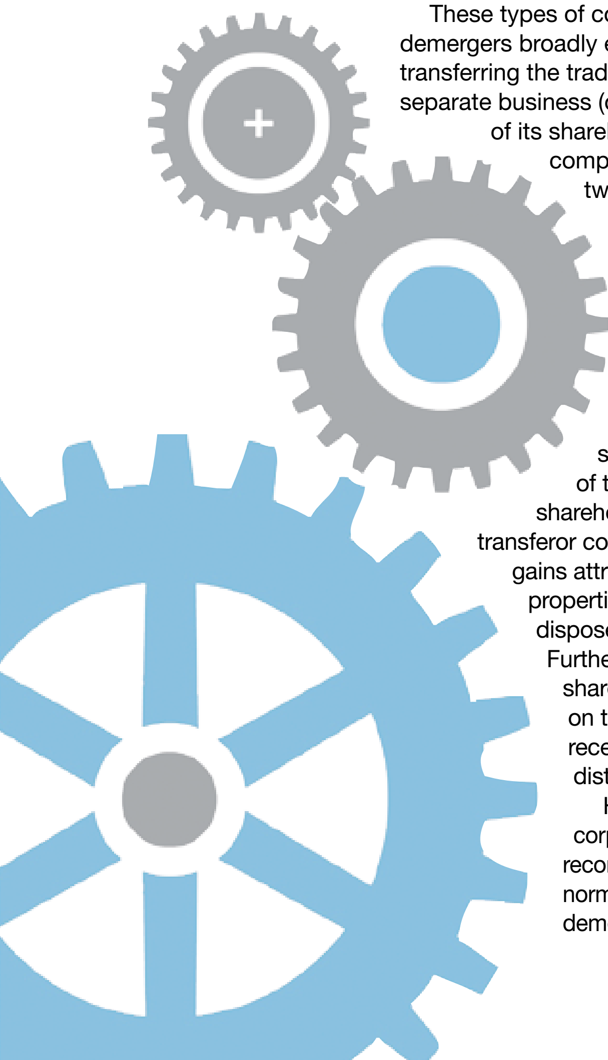
CORPORATE BREAK-UPS

The Finance Act 2011 contains some pleasant surprises for corporate reconstruction transactions, says Peter Rayney



The sentiment expressed in Neil Sedaka's 1962 classic hit 'Breaking up is hard to do' is perhaps apt in the field of corporate break-ups through a partition or demerger.

In the current business climate, many company reconstructions are being driven by the shareholders' desire to ringfence valuable investment assets from the ever-increasing risks attaching to the company's/group's trading operations. For example, a 'hybrid' trading/ investment company/group may wish to separate out its trading and investment activities into separate (new) companies. Alternatively, such reconstructions may also be required to facilitate a separation of the business due to a shareholder disagreement.

These types of corporate reconstructions/ demergers broadly entail the original company transferring the trade and assets of two or more separate business (or subsidiaries) to all or some of its shareholders. In essence, a company or group is divided into two or more companies/ groups, with the ultimate share ownership being maintained or separated.

Without 'special relieving' provisions, such arrangements could trigger significant tax liabilities for both the company and its shareholders. The distribution of the businesses to the shareholders would result in the transferor company being charged tax on gains attributable to goodwill and properties, etc (deemed to be disposed of at their market value). Furthermore, the recipient shareholders would also be taxed on the market value of the assets received by them, as income distributions.

However, using the special corporate and shareholder reconstruction reliefs, it should normally be possible to 'split' or demerge the relevant business activities on a tax-neutral basis (although, in some cases, there may be an unavoidable stamp duty or stamp duty land tax (SDLT) cost).

NON-STATUTORY DEMERGERS

This article will concentrate on 'non-statutory' demergers (sometimes called s110 Insolvency Act 1986 reconstructions) and the impact of the new Finance Act 2011 changes to the degrouping charge rules (see *A capital plan, June 2011, p70*). Unless stated otherwise, all statutory references are to the Taxation of Chargeable Gains Act 1992.

Under a non-statutory demerger, the company is wound up and the liquidator distributes the relevant 'businesses' and assets, and/or subsidiaries, to new companies owned by the shareholders, using the procedure laid down in s110, Insolvency Act 1986. The detailed procedure and tax consequences of an s110, Insolvency Act 1986 scheme, is explained in the case study example (see box).

HIVE-DOWN AND DEGROUPING CHARGES

Where different businesses are being split between different shareholder groups and there are 'substantial' unrelieved tax losses (as in the case study), it may be desirable for the company to hive down the businesses to separate new subsidiary companies before carrying out the reconstruction.

The hive-down will generally fall within the 'succession of trade' rules in Chapter 1, Part 22, Corporation Tax Act 2010, which enables the unused tax losses to be transferred to the new subsidiary for future use against its trading profits.

In the past, the downside with this route was the potential degrouping charge under s179. Where chargeable assets, such as property and/or goodwill, were transferred to the new subsidiary, they would initially have been transferred on a 'no gain/no loss' basis under s171 (the intra-group asset transfer rule).

However, a subsequent degrouping charge would be triggered when the liquidator subsequently distributes the shares in the subsidiary company as part of the s110 Insolvency Act 1986 arrangement. This is because the subsidiary will leave the capital gains tax group holding the relevant property and/or » goodwill. The taxable degrouping gain is based on a deemed 'market value' disposal (and re-acquisition) of the relevant asset immediately after the original intra-group transfer.

Under the pre-FA 2011 rules, this degrouping tax charge would arise in the subsidiary company. However, provided the tax charge was less than the value of the (transferred) tax losses, this was often considered a necessary cost of being able to access the tax losses in the future. Indeed, in most cases, if there were substantial accumulated losses, this generally meant that the market value of any goodwill, subject to the degrouping charge, was low or negligible. So the real problem in practice was often with property assets (which might also attract an SDLT clawback charge on degrouping).

Based on the facts of the case study, SB might not have any material degrouping charge (if the value of its trading goodwill is negligible) but CP is likely to have some taxable degrouping gains in respect of the investment properties that were transferred to it by TSCP.

RECONSTRUCTION RELIEFS

Provided the reconstruction satisfies certain conditions, the two key reconstruction reliefs in s139 and s136 should avoid a capital gains charge at both the corporate and shareholder levels.

The good news now is that, under the post-FA 2011 degrouping regime, it is also possible for capital gains degrouping charges to be relieved as part of the s139 corporate gains reconstruction relief.

CORPORATE GAINS

Once TSPC (case study company) is placed into liquidation, the liquidator will enter into an s110 Insolvency Act 1986 arrangement. As part of this process, TSPC's 100% subsidiaries (SB and CP) will be distributed to Newco A and Newco B respectively in consideration for an issue of shares to the relevant shareholders.

The s139 'corporate gains' reconstruction relief provisions would enable the shares in SB and CP (which are treated as businesses) to pass to Newco A and Newco B on a deemed 'no gain/no loss' basis.

Under the FA 2011 degrouping rules, where a subsidiary company leaves a group (via a share disposal which will usually be the case), the degrouping gain is normally added to the transferor company's disposal consideration (see new s179 (3D) as inserted by FA 2011). For the sake of completeness, s139 has also been amended to ensure that the deemed additional degrouping charge consideration does not affect the 'no consideration' condition in s139(1)(c).

In the context of a s139 'reconstruction' transfer, HMRC has now confirmed that the degrouping charge is eliminated as part of the deemed 'no-gain/no loss' consideration rule. This means that, in the context of TSPC's reconstruction exercise, CP's degrouping gains

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will effectively be exempted under the 'no gain/no loss' consideration rule in s139.

However, it also appears to be HMRC's view that the degrouping gain is not added to the deemed 'no gain/no loss' consideration which forms the base cost for the transferee company.

This new treatment is very favourable when compared to the pre-FA 2011 degrouping regime. The new FA 2011 rules apply to post-18 July 2011 transfers (or, to post-31 March 2011 transfers where an 'early commencement election' is made under para 9(4), Sch 10, FA 2011). Thus, if TSCP had implemented its reconstruction plan in January 2011, CP would have suffered a taxable degrouping charge under the 'old' regime.

POST-MARCH 2002 INTANGIBLES

There is one important exception to the FA 2011 degrouping. Where goodwill or other intangibles (which have been created or acquired after 31 March 2002) are included in the 'pre-reconstruction' hive-down, they will not be eligible for the beneficial degrouping charge treatment outlined above. This is because the corresponding intangibles degrouping charge in s780 CTA 2009 was not amended by the FA 2011.

Consequently, a hive-down involving post-31 March 2002 goodwill/other intangibles will not obtain any s139 relief on the subsequent reconstruction transfers of the shares in the subsidiary companies. An intangibles degrouping 'income profit' will therefore crystallise, with the profit being based on the excess of the market value over the tax value of the asset (ie, original cost reduced by the cumulative amortisation).

Care will therefore need to be exercised to determine whether any degrouping charge falls to be relieved under s139 or taxed under the intangibles rules.

PLANNING DEMERGERS

Each reconstruction project will be underpinned by a number of generic tax principles and reliefs. The FA 2011 changes will relieve many degrouping charges on certain types of company reconstruction. But, of course, there is a panoply of other tax exemptions and reliefs that must be considered in determining the optimum reconstruction route in each case. In practice, each one tends to have its own fairly unique issues and challenges, and it will not always be possible to implement a company reconstruction without any tax cost.

PETER RAYNEY FCA, CTA (Fellow), TEP
runs an independent tax consultancy practice, Peter Rayney Tax Consulting
peter@prtaxconsulting.co.uk

CASE STUDY

PARTITION OF THE SUPREME PROPERTY COMPANY LTD (TSPC)

The shares in TSPC have always been owned equally by Ross, Florence, Cindy and Mary (they are unrelated). TSPC initially started trading as a building contracting company but in recent years it has gradually built up a substantial portfolio of residential properties (in various ‘disadvantaged’ areas thus avoiding substantial amounts of SDLT).

The building contracting side of the business has suffered during the economic downturn and TSPC’s shareholders have been advised that the company’s valuable residential property investments can be protected from any future exposure to the risks inherent in the building contracting trade by implementing a company reconstruction under s110 Insolvency Act 1986.

As part of this arrangement, Ross and Florence wish to have no further interest in the building contracting trade but will retain their ownership of the residential property investment business. To compensate them, Ross and Florence will take a greater share in the property investment business going forward.

The building contracting trade has substantial unused trading losses (around £3.5m).

Although the reconstruction could take place in a number of different ways, the shareholders have agreed that the reconstruction will proceed as follows:

- TSPC will hive down its building contracting trade and property investment business to two new 100% subsidiaries - Supreme Building Ltd (SB) and Cosy Properties Ltd (CP).
- TSPC’s share capital will be converted into two separate classes of shares – A and B ordinary shares:
  - the A ordinary shares will be entitled to the profits, assets and voting rights relating to SB (i.e. the building contracting trade); and
  - the B ordinary shares will be entitled to the profits, assets and voting rights relating to CP (i.e. the residential property investment business).
- The TSPC shareholders will then put the company into liquidation.
- The shareholders will each form their respective new companies – Newco A (Cindy and Mary) and Newco B (Ross, Florence, Cindy and Mary).
- The liquidator will enter into a s110 Insolvency Act 1986 arrangement under which he will distribute:
  - the shares in SB to Newco A in consideration of an issue of shares in Newco A (to TSPC’s A ordinary shareholders);
  - the shares in CP to Newco B in consideration of a fresh issue of shares in Newco B (to TSPC’s B ordinary shareholders).

FIGURE 1

PRE-RECONSTRUCTION HIVE-DOWN

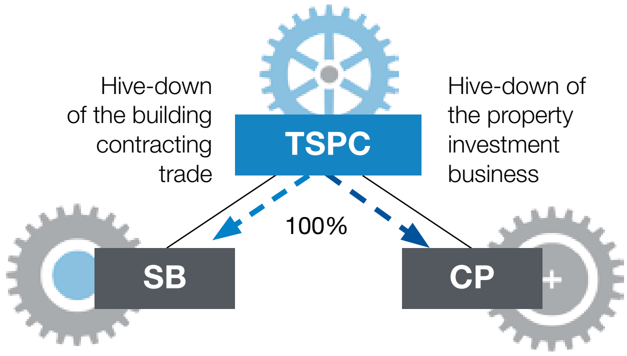

FIGURE 2

SECTION 110 INSOLVENCY ACT 1986 RECONSTRUCTION

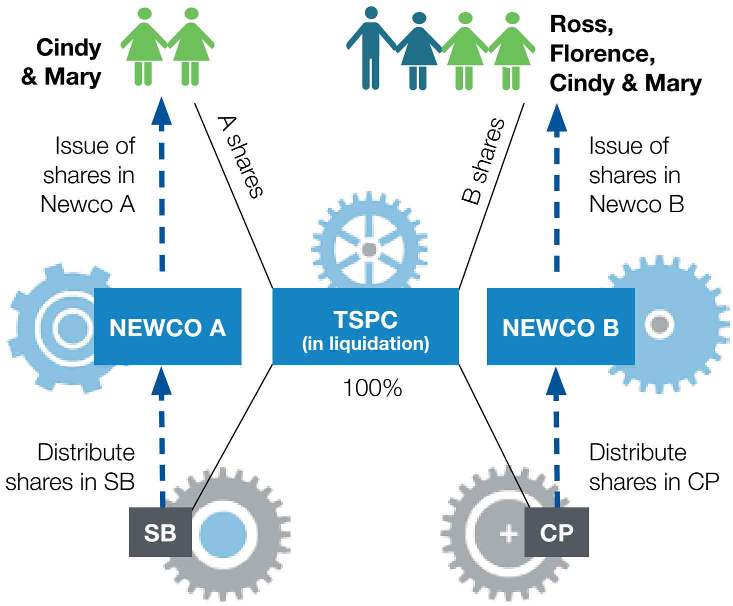

FIGURE 3

FINAL STRUCTURE