THE GREAT 'DEGROUPING' MAKEOVER

Peter Rayney explains the Finance Act 2011 changes

Way back in 2007, the corporate capital gains rules for groups were identified as being in need of simplification. And so that process began. After many hours of consultation and legislative drafting, Finance Act 2011 (FA 2011) contains the final results of this worthwhile exercise.

Of the changes, the revised degrouping charge rules probably have the widest practical impact. They frequently feature in many corporate disposals and are therefore the focus of this article.

The FA 2011 degrouping provisions apply to subsidiaries leaving a group after 18 July 2011, although it is possible to elect for them to apply from 1 April 2011 (by making an 'early commencement' election under para 9(4)–(6), Sch 10, FA 2011– note that this election must be made by 31 March 2012).

It is worth mentioning at the outset that the radical FA 2011 changes to the capital gains degrouping rules have not been mirrored in the corresponding degrouping provisions for intangibles (except for the revamped 'associated companies' degrouping exemption – see below). Therefore, given the different potential tax treatments, groups will need to identify carefully whether any goodwill subject to a degrouping charge falls within the capital gains or the intangibles regimes.

Background to degrouping charges

The degrouping charge legislation 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 intragroup transfers) in consideration for shares or 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.

Such planning techniques are now caught by the degrouping charge rules in (what is now) s 179, Taxation of Chargeable Gains Act 1992 (TCGA 1992). This is because s 179(4), TCGA 1992 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). A 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 off their activities some time after a group restructuring exercise. The mechanical nature of the provisions does 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 (prior to FA 2011) that subsidiary could still be exposed to a degrouping tax charge under s 179, TCGA 1992.

FA 2011 degrouping charge procedure

To deal with these concerns, Sch 10, FA 2011 introduced some radical changes to the mechanics of the degrouping tax charge.

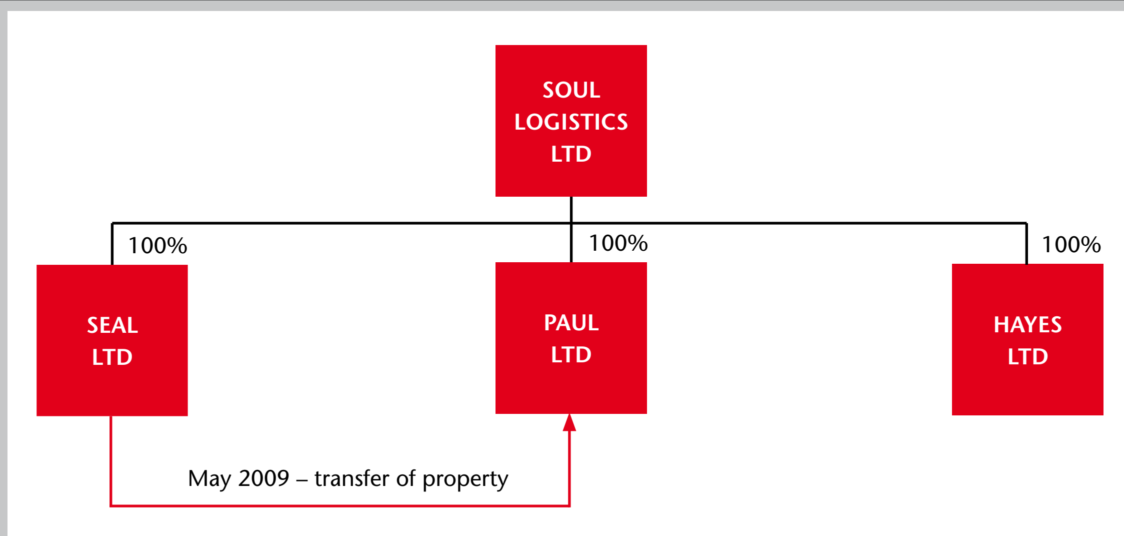
The actual degrouping gain/loss is still calculated on the same basis as before, ie the transferee subsidiary is deemed to sell and reacquire the relevant asset at its market value immediately after the previous intragroup transfer. However, where the transferee company leaves the group due to a disposal 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 (s 179(3D), TCGA 1992).

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 that exemption. The interaction between the SSE and revised degrouping rules is illustrated in the example below.

Where SSE is not available – for example, if the subsidiary is sold out of an investment group – the FA 2011 degrouping charge treatment still applies. In such cases, the taxable gain on the sale of the subsidiary, including the degrouping gain, would fall on the seller (subject to any reallocation election under the revised s 171A, TCGA 1992.

EXAMPLE

FA 2011 TREATMENT OF DEGROUPING CHARGES AND INTERACTION WITH SSE



Soul Logistics Ltd acts as the parent company of a haulage and logistics business. The current corporate structure has remained the same for many years (see above).

Soul Logistics Ltd is planning to sell its 100% shareholding in Paul Ltd for £2.5m. (The current 'indexed' base cost of the shares is £450,000.)

Paul Ltd had acquired its current warehouse premises from Seal 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 s 171, TCGA 1992. These office premises had been purchased by Seal Ltd in July 1991 for £500,000.

The sale of Paul Ltd takes place in January 2012. Soul Logistics Ltd's capital gain on the sale of its 100% holding in Paul Ltd should be exempt under the SSE rules. Furthermore, as a result of s 179(3A), TCGA 1992, there should be no tax charge on the degrouping gain in respect of the warehouse premises since it is added to the consideration for the 'exempt' Paul Ltd share sale.

The relevant calculations are as follows:

Sale of 100% holding in Paul Ltd	**£'000**
Share sale proceeds	2,500
Degrouping gain (see below)	405
Total sale consideration	2,905
Less: Indexed base cost	(450)
Capital gain	2,455
Less: SSE	(2,455)
Taxable gain	Nil

Degrouping charge	**£'000**
Deemed MV (May 2009) consideration	1,200
Less: Base cost	(500)
Indexation (£500,000 x 59%)	(295)
Capital gain	405

Share for share exchanges
Special rules apply where a subsidiary is disposed of in exchange for shares within s 135, TCGA 1992. In these situations, the degrouping gain is not charged on the share exchange due to the 'no disposal' fiction rule in s 127, TCGA 1992.In such cases, the degrouping gain is first deducted against the base cost of the new 'consideration' shares (as derived from the 'old shares' under s 127, TCGA 1992) but the deduction is limited to the base cost amount. However, where the degrouping gain exceeds the base cost (as will often be the case), it is brought into charge as part of the sale consideration on a subsequent disposal of the new 'consideration' shares by the seller (s 179(3E), TCGA 1992).

Other degrouping events
The original (pre-FA 2011) method for taxing the degrouping charge continues to apply where a company leaves the group otherwise than as a result of a share disposal by a UK resident company. This would be the case where, for example, a company leaves a group by virtue of a fresh issue of shares that 'swamps' the existing 75% group connection.

This rule is logical since an issue of shares would not (normally) trigger a CGT disposal, and so there would be no sale proceeds to which to attach the degrouping gain. The (pre-FA 2011) degrouping treatment is therefore retained in such cases, with the degrouping capital gain/loss arising in the subsidiary company. The degrouping gain or loss is deemed to arise at the start of the accounting period in which the 'target' subsidiary leaves the group (or, if later, at the date of the relevant intragroup transfer).

In such cases, an election can now be made under the (revised) s 171A, TCGA 1992 provision to reallocate the gain/loss to another group company.

Just and reasonable reduction of degrouping gain
It is perhaps an inherent part of corporate group tax for gains on the same economic profit to be taxed more than once. Gains which are subject to a degrouping charge might also suffer tax at a higher level in the group, for example, as part of the gain arising on a share sale.

The FA 2011 introduces s 179ZA, TCGA 1992 to deal with these concerns. Where it would be unreasonable for a degrouping gain to be taxed, the seller or 'target' subsidiary can make a claim for the gain to be reduced on a 'just and reasonable' basis (with a commensurate reduction also being made to the re-acquisition value).

Intangibles degrouping charges
Degrouping charges can also arise under the corporate intangibles regime, where the relevant assets are goodwill or other intangible assets created or acquired by a group after March 2002. Thus, where a subsidiary company is sold holding (post-March 2002) goodwill which it acquired from a fellow group member in the previous six years, a corporate intangibles degrouping charge will arise under ss 780–794, Corporation Tax (CTA 2009).

The intangibles degrouping charge is based on a deemed disposal and reacquisition of the goodwill/intangible at its market value at the date of the original intragroup transfer. Given that the intangibles regime is based on slightly different principles, the degrouping profit/loss will be based on the difference between the market value of the asset less its tax written down value (ie original cost less the accumulative tax-deductible amortisation to date). The relevant intangibles profit/loss is taxed/deducted in the 'outgoing' subsidiary immediately before it leaves the group. There will also be a consequential adjustment to the tax-deductible amortisation in the 'target' company, which would then be based on the current market value.

Unfortunately, FA 2011 did not make any corresponding change to the manner in which corporate intangibles degrouping profits/losses were dealt with. Consequently, even though SSE might be available to exempt the gain on the sale of the subsidiary, an intangibles degrouping charge would still arise in the subsidiary company. However, it is possible to reallocate an intangibles degrouping profit to another (75%) group member (s 792, CTA 2009) or it may be rolled over against qualifying reinvestment on goodwill/intangibles by the group (s 791, CTA 2009).

Associated companies exemption for degrouping charges
Where two or more companies leave the group together (in a 'sub-group' relationship), s 179(2), TCGA 1992 provides a potential degrouping charge exemption in relation to assets that have previously been transferred between those companies.

For many years, the majority of tax advisers considered that the wording in s 179(2), TCGA 1992 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 did not accept this interpretation, contending that s 179(2), TCGA 1992 effectively contained a further (implicit) requirement for the two companies to be in a sub-group relationship at the time of the original intragroup transfer of the relevant asset. This 'disagreement' was finally tested in *Johnston Publishing (North) Ltd v HMRC* [2008] EWCA 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.

Changes introduced by para 3, Sch 10, FA 2011 now give clarity about the relevant conditions that must be met to qualify for the associated companies exemption. The (revised) s 179(2), TCGA 1992 requires the transferor and transferee companies to be in a sub-group relationship throughout the period starting from the date of the intragroup transfer and ending immediately after they leave the group.

For these purposes, a 'subgroup' will exist where either:

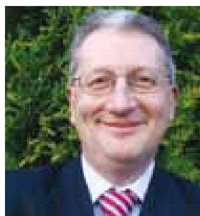
- both companies are 75% subsidiaries of another group company (condition A); or
- one of the companies is a 75% subsidiary of the other (condition B).

The same rules will also apply for the corresponding corporate intangibles 'associated companies' exemption in s 783, CTA 2009.

Radical revamp

The FA 2011 provisions relating to degrouping charges probably represent the most radical changes to the treatment of corporate group gains over the last decade or so. Where the seller group qualifies for SSE, the 'switching' of the degrouping gain to the seller's disposal consideration will have a very beneficial impact, since the total gains from the transaction should often be protected under the SSE code.

However, this will not be the case where the degrouping profit relates to (post-March 2002) goodwill, since the intangibles degrouping tax arises in the target subsidiary, although the seller's normal gain on the shares should still be exempt under SSE.



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