NEW KID ON THE BLOCK

It pays to structure corporate demergers under the relaxed capital reduction rules to take advantage of tax reliefs, says Peter Rayney

Company reconstructions and demergers for owner-managed companies seem to be particularly in vogue at the moment. A number of these cases involve the separation of trading and property investment activities carried on by the same company or group. Typically, the main objective will be to place the property investment and trading activities into separate entities. This often enables a valuable property investment portfolio to be insulated from 'trading' risks and may also bring inheritance tax (IHT) advantages for the shareholders.

The split of the separate business activities is usually achieved via a corporate demerger - the end result being that the trading and investment activities are run through separate companies owned by the same shareholder(s) or different groups of shareholder(s) from the original company.

PLANNING A CORPORATE DEMERGER

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 (original) 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. In some cases, there may be an unavoidable stamp duty or stamp duty land tax (SDLT) cost.

One of the most important requirements for any demerger is the need to avoid a taxable distribution arising in the shareholders' hands. Traditionally, this has been achieved by:

- a liquidation/non-statutory demerger under section 110 Insolvency Act 1986 (IA 1986) – since a distribution made in the course of a winding-up is not an income distribution

It will normally be possible for a demerger – equal to part of that value – to be made as a return of capital to the shareholders

(s1030, Corporation Tax Act (CTA) 2010); or

- a statutory demerger within chapter 5, part 23, CTA 2010 – this legislation provides that demergers satisfying the relevant conditions are not treated as distributions. It is necessary to ensure that a statutory demerger distribution of a (75% plus) subsidiary or trade is legally compliant, since the distributing company must have sufficient distributable reserves to 'frank' the demerger distribution (in the same way as any other dividend).

The statutory demerger code cannot be used to separate investment and trading activities, since it only applies to trading companies or groups. Thus, such cases have always been dealt with using a liquidation/non-statutory demerger under s110, IA 1986, which involves liquidating the company and incurring costs relating to the winding-up.

Understandably, some owner managers freak out at the prospect of such 'technical' liquidations even though steps can be taken to distance the company/business from the winding-up and associated public disclosure.

CAPITAL REDUCTION DEMERGERS

The Companies Act 2006 (CA 2006) significantly relaxed the rules enabling private companies to reduce their share capital. In recent years, it was recognised that these provisions can be used to implement corporate demergers, thus avoiding the potential problems associated with liquidations and so on. Furthermore, because of the need to remove all assets from the 'liquidated' company, a capital reduction-based demerger is often simpler and can often be planned to save SDLT costs.

A reduction of capital (which also extends to share premium accounts) can now be implemented fairly easily. It requires a special resolution made by the shareholders. Within the 15-day period before the resolution, the directors must support the capital reduction by providing a solvency statement complying with s 643, CA 2006. The solvency statement, which must be approved by each director, confirms that:

- there are no grounds for the company being unable to pay its debts now and over the next 12 months; and
- that any winding-up of the company within 12 months would be a solvent liquidation.

Importantly, there is no requirement for a supporting statement from the company's auditors. However, it may be useful for the company's accountants to prepare/review a suitable cashflow statement. After the special resolution is passed, the company must (within 15 days) send the Registrar of Companies:

- a copy of the special resolution;
- the solvency statement; and
- a statement of capital.

The statement of capital reflects the company's share capital after the reduction has taken place.

NO DISTRIBUTION FOR TAX PURPOSES

Under a capital reduction demerger, no distribution arises for tax purposes. This is because the shareholders' receipt of the shares in the demerged company represents a return of their original share capital (s1000 (1)B)(a), CTA 2010).

Clearly, this technique only works where the shareholders have subscribed a sufficient amount for their shares in the distributing company to 'frank' the demerger transaction.

Where this is not the case, it is possible to create significant share capital by implementing a company reorganisation. A capital reduction demerger is, therefore, often preceded by a share exchange transaction, which involves the creation of a new holding company (Holdco). The shareholders of the existing company exchange their original shareholdings for new shares issued by Holdco.

The tax and legal analysis here is as follows:

- From a CGT perspective, the new Holdco shares received by the shareholders take the place of their original shareholdings (assuming HMRC accepts that the share exchange is driven by commercial reasons). This

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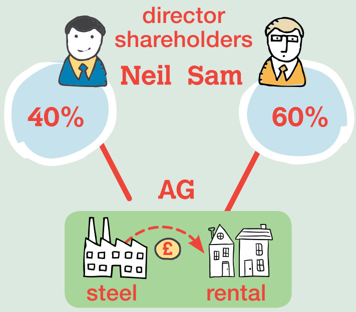
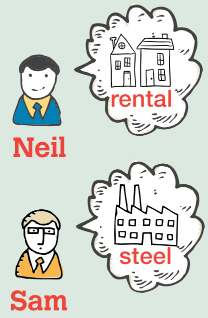
CASE STUDY – RETURN OF CAPITAL DEMERGER

Setting the scene

Sam and Neil are director-shareholders of Ash Green Ltd (AG), founded in 1954, holding 60% and 40% of its issued share capital respectively. Over the years, they have reinvested the profits from AG's steel fabrication trade into various properties, which were subsequently rented to third parties. There is no debt attaching to the business.



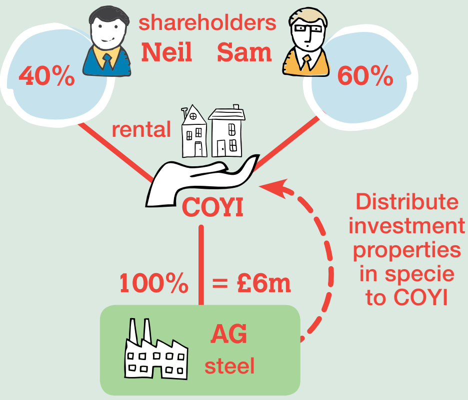
Neil has decided that he would prefer to 'retire' from the steel business and take over the property investment business. Sam will own and manage the steel trade. After taking professional advice, they have agreed that a corporate demerger using the 'capital reduction' procedure would be the most tax effective way of achieving this.



STEP 2: AG distributes investment properties in specie to COYI

There would be considerable commercial difficulties in transferring the steel trade from AG and it is therefore necessary to move the investment properties. This is achieved by making a distribution in specie of the properties to COYI.

AG has sufficent distributable profits to 'frank' the carrying value of the investment properties – the revaluation surplus in the accounts can be treated as 'realised' distributable profits for these purposes.



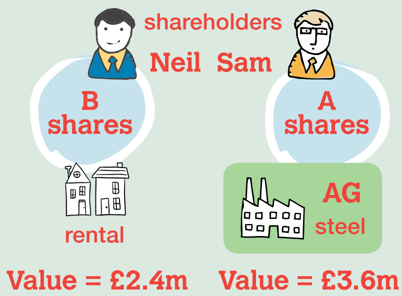
The investment properties are transferred on a no gain/no loss basis under s171, TCGA 1992 – no tax charge arises in AG.

The in-specie distributions are exempt from SDLT (since there is no consideration given) (para 1, Sch 3, FA 2003). The property investment business is a transfer of a going concern for VAT purposes.

STEP 3: COYI's share capital is reorganised. COYI then transfers its 100% holding in AG

Sam's and Neil's existing ordinary shares are reclassified as A and B shares respectively. The A shares carry all rights over the steel trade (carried on through AG) and the B shares carry all rights over the property investment business.

A valuation report shows that the steel business is worth £3.6m and the investment properties are worth £2.4m.



treatment is often referred to since the shareholders have legally disposed of their shares;

- In reality, the shareholders have subscribed for their new shares in Holdco at the (full sale) value of the shares they held in the original company. In other words, they have acquired the shares in Holdco at an amount equal to the market value of the original company. If the share exchange were accounted for under merger accounting principles, this value would not be recognised in the Holdco's accounts. However, the sale contract would state that Holdco had acquired the original company at market value, and this also represents the shareholders' subscription price for their new Holdco shares.

The subscription value of the Holdco shares represents the market value of the acquired company. Consequently, it will normally be possible for a subsequent demerger – equal to part of that value – to be made as a return of capital to the shareholders (ie, not out of Holdco's distributable reserves). Practical experience suggests that HMRC is satisfied with capital reduction demergers, provided they are properly implemented.

TAX REORGANISATION RULES

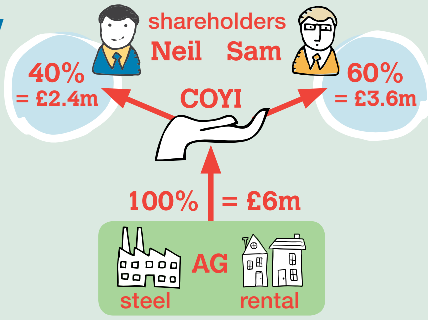
A 'reduction of capital' simply provides protection from an income distribution charge. Reliance must still be placed on the usual tax 'reconstruction' reliefs to avoid a capital gains charge at both the corporate and shareholder levels:

- s139, TCGA 1992 effectively prevents the company from incurring taxable gains on the relevant chargeable assets passing with the business, by deeming them to be transferred

Reliance must still be placed on the usual tax 'reconstruction' reliefs to avoid a capital gains charge at both the corporate and shareholder level

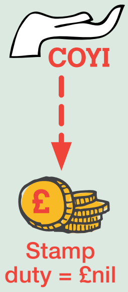
STEP 1: Insertion of a new holding company COYI

A new holding company COYI Ltd (COYI) will acquire 100% of AG (worth £6m) from Sam and Neil. In consideration for the sale of their AG shares, they are issued with new COYI shares on a 60%: 40% basis (worth £6m).

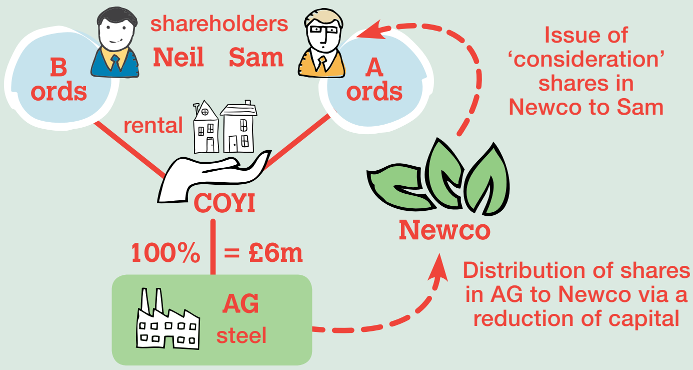


Provided HMRC accepts that the share exchange is driven by commercial reasons (confirmed by a s138, TCGA 1992 tax clearance), Sam and Neil will not trigger any CGT charge on the sale of their shares in AG (s135, TCGA 1992).

COYI should not pay any stamp duty on its acquisition of AG (s77 FA 1986). Sam and Neil effectively give £6m for their shares in COYI (reflecting the value of their AG shares).



COYI reduces its 'share capital' by £3.6m by making a distribution in specie of its 100% holding in AG (which holds the steel trade). The shares in AG must be transferred to a new company (Newco) to enable the corporate gains 'reconstruction' relief under s139, TCGA 1992 to be claimed.

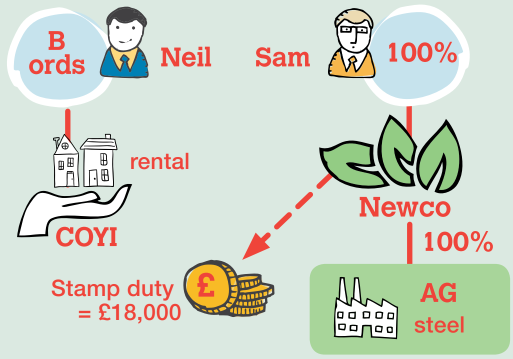


The transfer of the shares in AG to Newco is not a taxable distribution for Sam as it represents a return of capital. Although this does not prevent the 'receipt of value' by Sam from being a capital distribution, s136, TCGA 1992 applies to treat Sam's Newco shares 'stepping into the shoes' of his former COYI shares.

Final corporate structure

COYI transfers the AG shares (which are treated as a business) on a 'no gain/no loss' basis under s139 TCGA 1992. While COYI leaves the capital gains group (holding the investment properties) after it disposes of AG, HMRC should not seek a degrouping charge (since the 'the two company group practice' should apply – see HMRC 45410).

Since the shareholding in Newco (post-transfer) does not mirror that of COYI, stamp duty reconstruction relief will not be available. Hence, there will be a stamp duty liability of £18,000.



to the 'new' transferee company on a no gain/no loss basis. Any post-March 2002 intangible assets are dealt with in the same way under s818, CTA 2009;

- s136, TCGA 1992 provides tax neutral treatment for shareholders participating in the scheme of reconstruction. Thus, they are treated as exchanging their original shareholdings for the shares issued to them by the new 'transferee' companies. The normal CGT share reorganisation rules apply to treat the shares in the new companies as 'stepping into the shoes' of their old shares. Thus, the new shareholdings are treated as acquired at the same time and amount as the shareholders' original shares (with appropriate apportionments being made by reference to the market values of each new company).

The reconstruction reliefs are circumscribed by a 'genuine commercial purpose/no tax avoidance' requirement. It is recommended that all relevant tax clearances should be made before carrying out the relevant demerger.

CAPITAL REDUCTION DEMERGER

The mechanics of a demerger using the capital reduction rules under the Companies Act 2006 are best explained through the use of a case study (see case study above).

The tax rules on company reconstructions are complicated and involve almost all taxes. The case study can only provide brief guidance on the impact of the main tax provisions. Each reconstruction project will be underpinned by a number of generic tax principles and reliefs. There is a panoply of other tax exemptions and reliefs that must be considered 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.

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