What a wonderful day

PETER RAYNEY says tax advisers should be tickled by relaxations to the rules on the substantial shareholdings exemption.

Since its inception in 2002, the substantial shareholdings exemption (SSE) has provided a valuable corporate capital gains relief for the sale of trading subsidiaries and 'associated companies'.

As a brief recap for those unfamiliar with this relief, SSE enables a gain on a qualifying disposal of shares to be tax free (and a loss is not allowable). In broad terms, the SSE is currently available if, throughout a continuous 12-month period starting not more than six years before the disposal, the company (the 'investing company') held a 'substantial shareholding' (broadly, at least a 10% interest) in the company being sold (the 'investee company'). The exemption extends to assets related to shares.

However, the original SSE legislation contained some practical and technical difficulties that prevented the exemption being available on the sale of trading companies in specific cases; for example, if the 'selling' group did not satisfy stringent 'trading' criteria.

The good news is that these problems have largely been remedied by the beneficial relaxations in F(No 2)A 2017 which amended TCGA 1992. All references are to that Act. Here, we focus on the practical impact of these changes, which apply for all disposals made after 31 March 2017. Note that the new SSE relief for qualifying institutional investors, intended to encourage fund activity in the UK, is not covered here and nor does this article deal with rarer forms of the exemption.

Following the F (No 2)A 2017 amendments, there are now only two conditions for obtaining the main SSE:

KEY POINTS

- The substantial shareholding must now be owned for at least 12 months in the past six years.
- Two main conditions must be satisfied: the 'substantial shareholding' requirement and the 'investee company' trading test.
- The 'seller' must hold at least 10% of the ordinary share capital in the investee company.
- The investee company must qualify from the start of the 12-month 10% 'substantial shareholding' period.
- The legislation does not define 'substantial', but HMRC normally applies a 20% benchmark.

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- the 'substantial shareholding' requirement; and
- the 'investee company' trading test.

Substantial shareholding

The relevant shareholding investment must qualify as a 'substantial shareholding' held in the investee company throughout a 12-month period starting not more than six years before the shares are disposed of. Before 1 April 2017, this requirement was tested in the two years before the disposal.

To satisfy the 'substantial shareholding' requirement (see Sch 7AC para 8), the 'seller' group company must hold at least 10% of the ordinary share capital of (and 10% of specific economic rights in) the investee company – which may also be referred to as the target company; in other words, the entity being sold. Shares held by other members of the (51%) group in the same investee company are counted towards the 10% 'ownership test' (Sch 7AC para 9).

In practice, this condition is normally satisfied by the 'selling company' owning the 'substantial shareholding' throughout the 12 months before the company is sold. However, the condition is flexible enough for SSE to be obtained on the disposal of shareholdings of less than 10%. This is because the only requirement is that the 'seller' company must be able to trace back to a continuous 12-month period during which it held at least a 10% substantial shareholding in the six years before the relevant disposal – see ***Doddy Group*** (Sch 7AC para 7).

Consecutive periods of ownership by (broadly 75%) members of a corporate group can be added together to satisfy the required shareholding ownership test as long as the transfer of the relevant shareholding was either conducted on a no gain/no loss basis within s 171 or (from 1 April 2017) could have been were it not for the 'non-resident' status of a group member (Sch 7AC para 10).

DODDY GROUP

Sale of a less than 10% holding qualifying for SSE
Doddy Group Ltd acquired a 40% shareholding in a precision engineering company, Tickled Ltd, on 16 January 1985. The shares were disposed of as follows:

- On 26 May 2018, Doddy Group Ltd sold a 35% shareholding in Tickled Ltd (with the benefit of the SSE) but retained a 5% holding.
- On 11 September 2018, Doddy Group Ltd sold its remaining 5% stake in Tickled Ltd.

As long as Tickled Ltd remains a trading company until 11 September 2018, Doddy Group Ltd can also claim SSE on the sale of its 5% holding because it has held at least 10% of the ordinary share capital of Tickled Ltd throughout a 12-month period in the six years ending 11 September 2018.

'Investee company' trading test

The investee or target company in which the shares are held must be a qualifying trading company or the holding company of a trading group (or trading sub-group) from the start of the 12-month 10% 'substantial shareholding' period (see above) and ending with the disposal date (Sch 7AC para 19). If there is a gap between the exchange of contracts (the normal capital gains tax disposal date under s 28) and completion, this requirement must also be fulfilled up to completion.

An important relaxation to this rule was introduced by F(No 2)A 2017. For post-31 March 2017 disposals, it is no longer a normal requirement for the investee company to be a trading company *immediately* after the disposal. Before these changes, this condition created potential difficulties, such as when the acquiring company had immediately transferred the trade to another group member after the purchase. Because the selling company or group had no control over the investee company's actions after the sale, it had problems in ensuring this condition was satisfied. Reliance, therefore, had to be placed on contractual warranties from the acquiring company that it would ensure meeting this 'post-sale trading requirement'.

This is no longer an issue for most disposals. However, in effect, this amendment retains two important exceptions when the investee company is still required to remain a trading company/trading group member immediately after the disposal.

- When SSE is claimed on a sale to a connected company. This would apply where (for example) the shares in a trading subsidiary were sold to a non-resident group member and thus could not benefit from the no gain/no loss treatment under s 171.
- When reliance is placed on the special 'deeming' rule for trade hive-downs in Sch 7AC para 15A. In these cases, the (often new) trading subsidiary that received the hived-down trade must continue to carry on that trade immediately after its disposal out of the group (see 'Degrouping charges' below).

Trading company

For SSE purposes, a 'trading company' is one carrying on trading activities that *do not* include non-trading activities to any substantial extent (Sch 7AC para 20). The legislation does not define 'substantial', but HMRC normally seeks to apply a 20% benchmark to determine whether there are substantial non-trading activities.

Although the make-up of a company's gross assets is assessed for the purposes of the 20% test, it is important to apply the same evaluation to all the other measures of activity. These would include sales, income, expenses, and management time. Arguably, the profit and loss account measures are more indicative of the activities being carried on than a simple balance sheet assets evaluation. Having completed this exercise, it is important to weigh up all the facts and data and look at the activities of the company 'in the round'. Several inheritance tax business property relief cases (such as *HMRC v Brander (Executor of the Will of the late Fourth Earl of Balfour* [2010] All ER (D) 94) and HMRC guidance (tinyurl.com/ya7wf55p) should assist with this exercise.

Concerns are often raised about whether the holding of surplus cash might prejudice a company's trading status. In my view, the holding of cash or income can still be treated as trading-related if the amounts are earmarked for future trading use, such as when the cash forms part of the company's normal or anticipated working capital requirements. Further, the holding of surplus cash derived from trading cash flows can normally be ignored as long as it is not actively managed as an investment.

In some cases, HMRC may contend that the surplus cash should be counted as a non-trading activity and this may exceed 20% of the company's gross assets (including trading goodwill, which would not normally appear on the balance sheet). Similar issues may arise if a director-shareholder has a large overdrawn loan account because this would normally represent a non-trading asset. Nevertheless, in most of these cases, it is usual to find that the other profit and loss account and employee/management time measures are almost entirely trade-related. If this is the case, my experience is that HMRC would normally accept that the company qualifies as a trading company for SSE purposes. If there is an element of doubt, I normally recommend obtaining an advance non-statutory clearance from HMRC.

Clearly, the sale of a company that engages in investment activities (such as property letting) would not qualify for SSE. However, a non-controlling shareholding in a trading company may often qualify as a trading activity under the special joint venture rules (see below).

It is worth stressing that there is no residence test for the investee company. Thus, the sale of shares in a qualifying UK resident or non-resident trading company should, potentially, both attract the exemption.

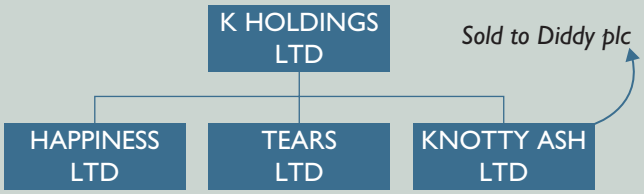
Holding company, trading group

A holding company of a trading group also qualifies and does not therefore have to carry on a trade in its own right. A 'trading group' is defined in much the same way as a singleton trading company. For these purposes, a group broadly consists of a

K HOLDINGS LTD

Typical SSE disposal out of a group.

K Holdings Ltd has had three wholly-owned subsidiaries for many years, as shown below.



The group is valued at £35m. However, in May 2018, it receives an offer to sell Knotty Ash Ltd to an unconnected company, Diddy plc, for £5m. Knotty Ash Ltd has always traded as a manufacturer of comedy props (including tickling sticks).

The disposal of Knotty Ash takes place on 18 August 2018, which gives rise to a chargeable gain of £4.8m.

The capital gain of £4.8m arising on the disposal of the shares in Knotty Ash Ltd should be exempt under the SSE rules for two reasons:

- because Knotty Ash Ltd has been wholly owned by K Holdings Ltd for at least the previous 12 months up to 18 August 2018, it satisfies the substantial shareholding test; and
- Knotty Ash Ltd ('the company invested in') has been a trading company for the 12 months to 18 August 2018.

Because this is a post-31 March 2017 disposal, the tax status of the K Holdings Ltd group throughout the substantial shareholding period and *immediately* after the disposal is now irrelevant for the purposes of determining the availability of SSE. Thus, it is not necessary to carry out a trading analysis of all the companies in the group and this eases the compliance burden considerably.

principal or parent company and its 51% subsidiaries on a worldwide basis.

A trading group is one that, taking together all the activities of the group, carries on trading activities, ignoring any non-substantial (in other words, no more than 20%) non-trading activities (Sch 7AC para 21). The legislative requirement to take together all the activities of the group ensures that any intra-group transactions are ignored. The group's activities are, in effect, looked at on a consolidated basis. Thus, for example, loans made or properties leased to another 51% group member are not regarded as investment or non-trading activities. See ***K Holdings Ltd***.

Some groups may hold non-controlling equity investments. These would normally be treated as a non-trading activity and, therefore, could prejudice the investee company's trading status, subject to the permissible 20% limit on investments and the like. However, most types of joint venture investments should benefit from the beneficial transparency rule in Sch 7AC para 23. This provides that, if the investee company or group holds at least 10% of the (underlying) ordinary shares in the joint venture company (JVC), it should generally be possible to treat it as carrying on an appropriate part of the JVC's trade. Consequently, the investee company or group is deemed to carry on the appropriate part of the JVC's trading activities. (However, this beneficial treatment applies only if five or fewer individual or corporate shareholders hold 75% or more of the JVC's ordinary shares.)

Non-statutory clearance

Given the substantial sums that may be involved in an SSE claim, if there are any potential doubts or concerns about an investee/target company's 'trading' status, it is generally prudent to seek an assurance from HMRC by applying for a non-statutory business clearance (tinyurl.com/y8t8bplp).

Before 1 April 2017, most non-statutory clearance applications were made because of uncertainties about the 'trading' status of the *investing* group – thankfully the F(No 2)A 2017 relaxations remove the need for such a process.

HMRC will accept clearance applications if there is a material uncertainty over the SSE status of an impending transaction (see HMRC's *Business Brief 41/07*). The application should cover the various matters on HMRC's checklist (tinyurl.com/yd72lb2b). In the context of an SSE application, this would include:

- the reasons for the transaction;
- the relevant facts;
- the company's view of the application of the SSE rules to the disposal; and
- the issues on which HMRC's opinion is sought.

HMRC may reject or not respond to an SSE clearance application if it does not explain in sufficient detail the genuine uncertainty inherent in the availability of SSE.

Seller's status now irrelevant

Since 1 April 2017, no statutory trading requirement is placed on the investing company or group – that is to say, the company or group making the relevant disposal. This is probably the most beneficial change introduced by F(No 2)A 2017 and it brings many important benefits. There are three of principal importance.

- It is no longer necessary to conduct a detailed analysis of all the activities of the group both before and after the disposal. This is particularly beneficial for 'large' multinational companies that may have different types of entities, subsidiary or joint venture accounts prepared in foreign languages, complex ownership structures and so on. The only relevant consideration is the trading status of the investee company.
- An investment company or group can now sell a qualifying trading subsidiary with the benefit of SSE.
- A company can sell its sole trading subsidiary and obtain SSE without further complications. Before 1 April 2017, the seller company had to be trading company immediately after the disposal. Consequently, the only way to access SSE on the disposal of the subsidiary was to use the tortuous provisions in Sch 7AC para 3. This entailed liquidating the seller company after the disposal. The proceeds would therefore be distributed, triggering a capital gains tax charge at shareholder level.

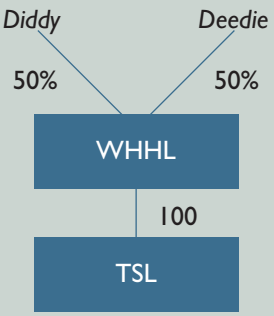
WEIRD HAIR HOLDINGS LTD

SSE on sale of a single trading subsidiary

Weird Hair Holdings Ltd (WHHL) purchased 100% of the issued share capital of Tickling Sticks Ltd (TSL) as a result of a buy-out transaction in 2010. TSL is a manufacturing company and has no investment-related activity.

Diddy and Deedie (who are married to each other) hold equal shareholdings in WHHL.

The shareholding structure is as follows:



On 11 March 2018, Diddy and Deedie were approached by Palladium Props Ltd, which offered to purchase the shares in WHHL (to obtain TSL's business) for about £3.5m.

However, after taking advice, they decided to sell WHHL's 100% holding in TSL instead for about £3.5m. This generated a (net) chargeable gain of some £3.4m, which was 'tax-free' under the SSE provisions.

Diddy and Deedie intend to use all the net sale proceeds received by WHHL to purchase a portfolio of commercial properties. WHHL would therefore become a family property investment company with the sale proceeds being reinvested without any tax charges.

Note that this would not have been possible under the pre-1 April 2007 SSE regime.

This third advantage allows the seller company to remain in existence and start a new business activity, possibly becoming a family investment company. In the right circumstances this would be far more tax-efficient because the proceeds of sale could be reinvested without incurring any tax charges (see ***Weird Hair Holdings Ltd***).

Degrouping charges

A capital gains (or intangibles) degrouping charge may be triggered if a company leaves a corporate group holding an asset that was transferred to it within the previous six years from a fellow group member. As a result of the changes made in 2011, if the sale of a trading subsidiary company qualifies for SSE, any *capital gains* degrouping charge will also, in effect, attract the exemption. This is because degrouping gains are now added to the seller's sale consideration for the disposal of the subsidiary and thus form part of the exempt gain under SSE (s 179(3D)). Of course, if the sale of the subsidiary does not attract SSE, the degrouping gain would be taxed as part of the seller's capital gain on the sale of the shares.

Under the basic SSE rules, this degrouping protection would not have been available if a trade is hived down to a new subsidiary that is sold soon afterwards. This is because the shares in the new subsidiary would not usually have been held for the minimum 12-month shareholding period.

In such cases, Sch 7AC para 15A comes to the rescue. In effect, it provides a deeming rule that treats the SSE substantial shareholding ownership period rule as being satisfied (in other words, extended) for any period that the 'hived-down' asset (such as goodwill or property) has been used by a member of the group. This provision generally enables the 12-month substantial shareholding condition to be satisfied on the sale of the (new) subsidiary, which can therefore benefit from SSE.

I should stress that HMRC considers that this rule cannot be applied to hive-downs from a singleton trading company. This is based on a strict interpretation of the wording in Sch 7AC para 15A (2)(d) that 'the asset was previously used by a member of the group' – see HMRC's *Capital Gains Manual* at CG53080C.

Some prudent singleton companies might even consider setting up a £100 dormant subsidiary to access the benefit of this deeming rule in future.

> ***"The F(No 2)A 2017 amendments did not change the anomaly with degrouping charges that arise under the corporate intangibles regime."***

The F(No 2)A 2017 amendments did not change the anomaly with degrouping charges that arise under the corporate intangibles regime. Unfortunately, the beneficial SSE treatment does not cover degrouping charges on intangible profits – such as those on goodwill relating to trades that started after 31 March 2002. Now that tax amortisation relief has been abolished for post-31 March 2002 goodwill, there is no real justification for this difference in treatment. In other words, degrouping capital gains can be exempt with SSE, but intangible profits on degrouping remain taxable!

Final thoughts

In my view, the F(No 2)A 2017 amendments to the SSE make the relief far more user-friendly. In particular, the complete removal of the selling company trading status rules provides far more flexibility in terms of planning and make SSE available in a wider range of cases. So what a wonderful day for selling some shares, waving your tickling stick and shouting 'How's that for an exemption?' through the letterbox at your local tax office. Assuming you have a tax office near you and it has a letterbox of course!

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