DISPOSALS BY COMPANIES WITH SUBSTANTIAL SHAREHOLDINGS

by David Goy

The new exemption regime for substantial shareholdings applies as from 1 April 2002. Its purpose, according to the Government, is to enable "groups wishing to restructure for commercial reasons [to] be able to do so without essential business decisions being constrained by the tax system" Certainly its introduction will have a significant impact as regards tax planning. Historically, tax planners have laboured long and hard on occasions to work out how tax charges on sales of subsidiaries can be minimised. Arrangements involving intra group dividends, asset transfers, the use of loss companies have regularly fallen to be considered. In future, certainly in the context of trading groups, the first question likely to arise is, does the new exemption apply? Companies often have a choice whether to sell business assets or shares. The availability of the new relief may now tip the balance, in certain circumstances, in favour of a share sale.

The major significance of the new exemption is likely to be seen, not merely when sales are being considered but also in planning forms of corporate structure. Offshore holding companies have been used in the past to preclude chargeable gains arising on sales of subsidiaries from being taxed. In future, in the context of trading groups, UK holding companies may be just as good.

One initial point to be made about the relief is that where it operates so as to preclude a gain from being chargeable, it also prevents a loss from being allowable. A curiosity of the new exemption, therefore, is that while it may not always be easy for a transaction to fall within it, if it does, it may be difficult then to arrange matters so that it falls outside it. The aim is not to allow a taxpayer to avoid realising chargeable gains, while at the same time, in like transactions, enabling it to realise allowable losses.

The Relief in General

The new exemption is contained in a new Schedule 7AC TCGA 1992 added by s.44 FA 2002. In brief, what the new relief provides is that a gain on a disposal of shares after 31st March 2002 is not a chargeable gain if a number of conditions are satisfied:-

(i) The disposal must be by a company (see paragraph 1)

The relief is not available to individuals or trustees.

It should be noted that there is no requirement that the company is resident in the UK. While a non-UK resident company is not normally concerned with tax on chargeable gains, the relevance of this point arises in connection with section 13 TCGA 1992 and the attribution of gains made by non-resident companies to UK resident shareholders. Section 13 only apportions “chargeable gains” and hence if the relief applies there is nothing to apportion. Thus where, for example, a

structure has been set up, possibly to obtain the benefit of a double tax treaty, under which an offshore holding company holds an investment in a subsidiary trading company, there should be no need to move that investment into a UK company in order to obtain relief.

The only circumstance in which the residence of a company is directly relevant is where it is sought to obtain the benefit of paragraph 3. This is a provision referred to below, but in broad terms it gives relief where the conditions otherwise necessary to be satisfied in order to obtain the relief are not satisfied but would have been satisfied had the disposal been made at some time in the previous two years. In such a case the company making the disposal must either be resident in the UK or a gain accruing must be within the charge to corporation tax (see paragraph 3(2)(c)). This requirement may have relevance in a case where a non-resident company has gains apportionable under section 13 TCGA 1992 and wishes to realise losses to reduce the charge to tax on its shareholders. As we will see, if the company has a loss-making subsidiary, it might deliberately try to fail the conditions required to be satisfied in order to obtain the relief, with a view to realising an allowable loss on the disposal of shares. Such a course might be possible for the non-resident unaffected by paragraph 3, when it would not be possible for a resident company. Save as regards paragraph 3, the Schedule is generally unconcerned with the residence of companies. Thus it is immaterial where the company in which shares are disposed of is resident.

Likewise, when groups are looked at in the Schedule, the reference is to worldwide not UK groups.

(ii) The disposal is of shares in a company in which the company making the disposal has a substantial shareholding (see paragraph 7)

The particular point to note here is that the relief is not a relief for disposals of substantial shareholdings, but is a relief for disposals, where the company making the disposal has or has had a substantial shareholding. The requirement is that a company must have had a 10%+ holding for at least 12 months in the two years preceding the disposal. So by way of illustration, if a shareholder has 11% now and sells 5%, he can obtain relief on the sale of his remaining 6% so long as he sells it within 12 months of the first sale.

(iii) The relief is a relief for disposals of interests in trading companies

Both the vendor company and the company in which the shares are sold must satisfy a trading requirement throughout the period commencing at the beginning of the latest twelve-month period by reference to which the substantial shareholding requirement is met, and ending at the time of the disposal. They must also satisfy a like requirement immediately after the disposal (see paragraphs 18 and 19). The trading requirement is broadly that the company is a sole trading company or member of a trading group. The reference to groups in this context is to the capital gains tax definition, save for the substitution of the 51% test for

the 75% test (see paragraph 26). As already mentioned, this will mean that international groups will have to be looked at as one, in order to see whether the exemption is available. Concentration on UK resident companies will not determine the issue. While there are quite complex provisions to be applied to determine whether the trading requirement is met, there are no provisions like those which feature in other legislation under which certain sorts of trades do not qualify (e.g. IHT business property relief, which excludes share dealing and land trading).

For completeness one point should be made at this stage. Reference has been made to the relief as a relief available on the disposal of shares. There is a small qualification to this, in that relief may also be available on the disposals of certain "assets related to shares" (e.g. options to acquire shares). This is provided for in paragraph 2, but nothing more is said about it in this article.

What are now considered are a number of more precise points about the relief. No attempt is made in this article to give exhaustive coverage of relevant points, but reference is made to a number of points that have arisen in practice – some simple; some not so.

1. Paragraph 5

As almost a knee-jerk reaction, the Revenue, when introducing a relief, become over-concerned with it being used for tax avoidance. So in Schedule 7AC there is in paragraph 5 an anti-avoidance paragraph, which

precludes the relief being available in certain circumstances. Paragraph 5 applies if there are arrangements of a certain sort from which

> "the sole or main benefit that could be expected to arise in that the gain on the disposal is by virtue of the Schedule not a chargeable gains".

This is a bit like section 787 ICTA 1988 regarding interest payments. On the whole it is unlikely to apply save in the rarest of circumstances.

It is not all arrangements that can be caught, but only those of a defined sort. These are arrangements pursuant to which an untaxed gain accrues to the company, and before the accrual of that gain

> the disposing company acquired control of the company (the shares in which are disposed of); or

> there was a significant charge in trading activities affecting the company the shares in which are disposed of.

Any structures set up before the proposal to introduce this relief was announced can hardly be said to be arrangements the sole or main benefit from which could be expected to arise is the obtaining of relief under the Schedule. In addition it is doubtful that the paragraph will ever apply to any normal commercial structure. The sole or main benefit requirement will not be met. Sales will occur because of commercial motives. In this

connection, the Revenue have given the following illustration of when paragraph 5 may apply:-

> "The provision is intended to counter a situation where what is essentially an investment return is dressed up as an exempt capital gain. An example might involve a package of derivatives designed to produce a guaranteed return being acquired by a company (company B which is controlled by company A). Alternatively, company B could already hold such a package and be acquired by company A. It is claimed the derivatives are assets of a financial trade being carried on by company B – the trade may have commenced only with the arrival of the derivatives package and they may be the only assets of company B. Alternatively, company B may have had a small pre-existing, probably related, trade. The shares in company B would be sold by company A before any return on the package of derivatives is taxed. This may be because any income is not taxed on an accruals basis or because the package produces a return only on exercise or sale and there is nothing that could be taxed before that point. The sale may be back to the provider of the derivatives package, so that any profits and losses match. But for the anti-avoidance rule company A would have obtained what is in effect an investment return on its 'deposit' as an exempt capital gain".

The essential point arising from the above is that the circumstances being referred to are, to put it mildly, unusual.

2. <u>The substantial shareholding requirement</u>

This requires a minimum 10% shareholding throughout a twelve-month period in the last two years

preceding the disposal. The 10% shareholding requirement involves

> ownership of not less than 10% of the company's ordinary share capital;
>
> entitlement to not less than 10% of the profits available for distribution to equity holders;
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> entitlement, on a winding up to not less than 10% of the assets available for distribution to equity holders.

All of these requirements must be met. To illustrate the position, let us suppose Company A is a parent and proposes to sell one of its subsidiaries, Company B. All the requirements for the new relief are satisfied. Company A owns all the shares in Company B. Unfortunately Company A does not want the exemption to apply because it is going to make a loss on the sale of Company B. What can it do? One possibility might be for the share capital of Company B to be re-organised so that a new class of shares is issued to a person (not being another company in the group) which represents more than 90% of the ordinary share capital but which has very limited economic rights, these rights being retained by Company A. Whether this is possible or not will depend upon a whole range of factors including the size of the share capital of Company B. If it has 100 £1 shares, such a course might not be difficult; if it has many millions it may be more difficult.

Note:-

the new shares cannot be held by a group company (because of paragraph 9);

the course would involve degrouping Company B;

even if such a course is feasible there would have to be a twelve-month delay;

such an arrangement would not be affected by paragraph 3 because the requirement in paragraph 3(2)(a) would not be met.

In determining whether the substantial shareholdings requirement is met two particular rules apply:

(i) holdings of group companies are aggregated (paragraph 9);

(ii) the period for which a company has held shares is extended by any period during which the shares were held by a company which disposed of them to the company concerned on a no-gain no-loss disposal e.g. an intra-group disposal under s.171 (see paragraph 10).

The operation of these rules is not always as straightforward as it might seem. Let us take an example. Company A is a non-resident parent of a group. It transfers shares in Company C to Company B, a company resident in the UK. Company B has only

recently been formed. All the companies are members of the same group. Shares in Company C have been held by Company A for many years, but Company B only has just acquired the shares when it is decided to sell them. Here:-

(i) Company B, of itself, does not satisfy the substantial shareholding requirement.

(ii) No reliance can be placed on paragraph 10: there is no disposal at no gain or loss, because Company A is non-resident.

(iii) Can there be reliance on paragraph 9?

Company C is treated as holding shares held by another member of its group. Can it apply though in respect of a period when Company B did not exist and was not therefore a member of a group? Two interpretations are possible. First it can be argued that if a company is a member of a group at the time of the disposal in question, it can be treated as holding and as having held any shares held by a company which is at that time a member of a group. The alternative approach is that the deeming only works while companies are members of the same group at the same time. Hence if a company does not exist the paragraph cannot apply. I take the latter view of the position. Typically, if there is a difficulty it is a problem fairly easy to rectify, either by a transfer of the shares to another company in existence throughout the period in question, or by an election under s.171A TCGA that another Company in the group

throughout such period should be treated as making the disposal.

3. <u>The trading requirement</u>

The only general point to be made about the trading requirement in paragraph 19 and onwards in the Schedule is that the greatest uncertainty as to the applicability of the relief will arise from this requirement. The requirement is that a company or group concerned must carry on trading activities where its activities do not "include to a substantial extent activities other than trading activities" (see paragraphs 20(1) and (21)(1)). The Revenue have said that the same approach will be adopted, as to what is "substantial" as for taper relief purposes (as to which see the Tax Bulletin June 2001). As to this they say that "substantial" means more than 20%.

One particular point to note is that in considering whether there is a trading group, the activities of the members of the group are treated as one business, with the result that activities are disregarded to the extent that they are intra-group activities (see paragraph 21(5)). In certain circumstances, holdings of shares in joint venture companies are disregarded, and a company is itself treated as carrying on a proportion of the activities of the joint venture company (see paragraph 23). In this situation there is nothing to say that services provided to the joint venture company are to be disregarded. Thus if a group company leases property to the joint venture company, that activity will be non-trading and will be taken account of in determining the trading status of the

group, even though, had the joint venture company been a subsidiary, it would have been ignored.

I now revert to the position where a company to be sold will be sold at a loss, where the desire is to fall outside rather than within the relief. I have already mentioned one particular course that might be adopted so as to preclude the substantial shareholding requirement from being satisfied. But as I have said even if that is feasible it will involve a twelve-month delay. As a result of this, it may be thought that if losses will be crystallised there may be more merit in seeking to ensure that the trading requirements are not met.

> Example. Company A owns all the shares in Company B, a trading company. All the conditions for obtaining the relief are satisfied, but because, if the shares are sold, a substantial loss will arise, the effect of the relief is disadvantageous. What is proposed therefore is that the trade of Company B is transferred at market value to a fellow subsidiary, Company C. Company B will then cease to trade and subsequently it will be wound up. Will an allowable loss arise?

The argument is that the relief will not apply, because Company B will not satisfy paragraph 19, in that Company B will not be a trading company immediately after the disposal. A problem arises, however, because of paragraph 3, which provides an exemption broadly where the conditions for relief have been met in the preceding 2 years. This paragraph is as much concerned

with preventing allowable losses as giving relief from gains. The following is said as to the effect of paragraph 3 in the Treasury's notes on the Finance Bill:-

> "Thus, for example, where the company invested in ceases to trade on being placed in liquidation, any gain accruing to the investing company on a disposal of shares in that company in the following two year period is potentially exempt under this paragraph. And where the trade of the company invested in is transferred elsewhere (within a group, for example), any loss on the disposal by the investing company on shares in that company within the two year period after the company invested in ceased to be a trading company is potentially not allowable."

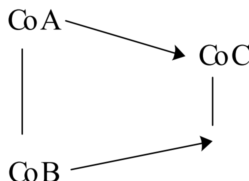
In the example I have given, paragraph 3 would operate to prevent losses being allowable unless there is a two year delay. It would not be the case, however, if Company A did not control Company B (see paragraph 3(2)(e)). The effect of paragraph 3 is important to consider, where a trade ceases, with the company invested in being subsequently disposed of or liquidated. If a gain is to accrue, the aim typically will be to ensure that it is crystallised within 2 years from the termination of the trade. If a loss is to accrue the aim will be to defer the disposal for more than 2 years. For these purposes it should be noted that the time of the disposal is the time of contract, even if the contract is conditional (see paragraph 3(7)). It may be that paragraph 3 can operate to provide relief in somewhat unexpected circumstances. Suppose that Company A is the parent of a large trading group and owns Company B, which carries on a trade

from a variety of premises. It is desired to enter into a sale and lease back transaction of these properties. If Company B does this chargeable gains will apply. Let us suppose, however, that Company B's trade is transferred to Company C (intra group) and a lease is granted to Company B of the premises concerned. Company B, at this stage, ceases to be a trader and its shares are sold to the outside investor. Is relief available on the sale? On the face of it no, because of the requirements of paragraph 19 not being met. A trading company is not being sold. But why does paragraph 3 not apply? In this connection it should be noted that shifting value into Company B in order to obtain the benefit of the relief is difficult. If there are intra-group transfers s.179 will apply on a sale of Company B. In this connection gifts into such a company protected from charge by s.165 TCGA 1992 will not enable gains to be protected (albeit losses will still be non-allowable see paragraph 3(5)).

4. The position on share exchanges

Paragraph 4 has the effect that the exemption can apply on transactions which do not normally give rise to disposals (e.g. share reorganisations falling within s.127 TCGA 1992). In such cases chargeable gains will arise on the disposal, and the company concerned will have a new base value for the new shares acquired.

Example



– In the above example relief will be available on Company A's disposal of the shares in Company B. If Company A subsequently disposes of shares in Company C, it will have to wait 12 months to get relief. Likewise Company C will get relief on a sale of Company B only if it waits for 12 months.

The position is more complicated if all the companies are in the same group. In such a case, it is not thought that a disposal will bring the exemption into play. This is because paragraph 4 requires it to be assumed, in seeing whether the exemption applies, that s.127 does not operate. On that assumption, the exemption would not apply, because the disposal would be within s.171, and paragraph 6 says that such a disposal is excluded. On this basis the taxing provisions operate normally and without regard to the Schedule. In these circumstances, on a disposal by Company A of new shares acquired in Company C, periods of ownership before the exchange can be taken account of by virtue of paragraph 14. On a disposal by Company C of Company B, Company C will not be able to take

advantage of paragraph 10 (because no s.171 disposal can be taken advantage of). Paragraph 9 will be able to be taken advantage of, but only in respect of periods during which Company C has been a member of the group.