Exempt distributions: time for change?

Relief under the exempt distribution provisions in Chapter 5, Part 23, CTA 2010 may apply to a demerger structured as either a direct dividend demerger or an indirect dividend demerger (see below for more detail on the mechanics of the two structures).

Where exempt demerger relief applies, a distribution of assets to shareholders does not give rise to an income tax charge; instead they should expect a capital gains rollover. The distributing company should not suffer a chargeable gain on the disposal if the substantial shareholding exemption applies (or, in the case of an indirect dividend demerger, if rollover relief applies). Furthermore, de-grouping charges are turned off for the demerging companies when they leave the distributing company’s group.

Numerous strict conditions and tests must, however, be satisfied in order to bring a distribution within these provisions. Most of the conditions derive from the original exempt distribution provisions introduced in 1980. The purpose of these provisions was two-fold: to relieve the distributing company from an advance corporation tax (ACT) charge, which would otherwise have applied, and to prevent shareholders from receiving a taxable income distribution.

It is, of course, the case that other demerger mechanics may be available to implement a tax-efficient demerger if the exempt distribution conditions cannot be satisfied, notably reduction of capital demergers involving a scheme within Part 26 of the Companies Act 2006 (as implemented, for example, by The Carphone Warehouse when it demerged Talk Talk in 2010) and liquidation scheme demergers. These structures can still allow shareholders to avoid an income tax charge and to benefit from capital gains rollover relief on the demerger. No specific relief is, however, available to turn off de-grouping charges.

Do the numerous and wide conditions mean that the exempt distribution provisions no longer strike the right balance between relieving commercial transactions and preventing abuse of the relief? Do they remain a relic of the ACT regime in need of modernisation? We would note that, when the original rules were introduced in 1980, a desire was expressed in the House of Commons to keep the rules under review in order to ensure that relief continued to be available for commercially motivated transactions but not for transactions undertaken to avoid tax.

DIRECT DIVIDEND DEMERGER MECHANICS

A direct dividend demerger involves a distribution by the distributing company of its shares in one of its wholly owned subsidiaries, the demerging company, to the distributing company’s shareholders (see Figure 1).
INDIRECT DIVIDEND DEMERGER MECHANICS

Instead of the demerging company being distributed directly to shareholders, an indirect dividend demerger involves all the shares in the company to be demerged being transferred to a newly incorporated company ("Newco") whose shares would be issued to the distributing company’s shareholders in satisfaction of a dividend declared by the distributing company (see Figure 2).
KEY EXEMPT DISTRIBUTION CONDITIONS

EU residence
Each "relevant company" must be resident in an EU Member State.

In the case of direct and indirect dividend demergers, the distributing company and each subsidiary whose shares are transferred are relevant companies. In the case of an indirect dividend demerger, the company to which the demerging company's shares are transferred is also a relevant company.

When the exempt distribution provisions were introduced, each relevant company had to be resident in the UK. Since 2009, each relevant company must be resident in an EU Member State.

In the context of a tax code where dividends paid by companies resident within and outside the EU are treated in broadly the same way, this condition seems odd – a quirk of history.

The extension from the UK to the EU was clearly made with an eye to the risk of an EU challenge. But once the decision had been taken to extend the availability of the relief to EU companies, why wasn’t this taken to its logical conclusion and the condition amended to encompass companies worldwide?

It is not obvious what policy lies behind denying UK resident shareholders in a non-EU company the benefit of exempt distribution treatment on a commercially motivated demerger. When one purpose of the relief was to relieve the company of an ACT charge, restricting the availability of relief to UK companies made sense; now it seems outdated.

Trading
A number of the exempt distribution conditions focus on the requirement that the distributing company and the demerging companies should meet certain trading requirements. For example, the distributing company must be a trading company or member of a trading group and the demerging company must be a trading company or the holding company of a trading group.

The exempt distribution provisions thus assist only in the division of two trades; they cannot be used to facilitate the split of a trading activity and an investment activity. That the 1980 Parliament intended the rules to be used in this way only is made clear by what is now s. 1074 CTA 2010, the provision setting out the purpose of the demerger provisions. HMRC accept that other demerger structures can, however, be used to achieve a split of trading and investment activity in a tax-efficient manner. Given this, it is not clear why that type of demerger should continue to be excluded from the specific exempt demerger relief.

No tax avoidance purpose
The distribution must not form part of a scheme or arrangement the main purpose (or one of the main purposes) of which is the avoidance of tax (which includes stamp duty and SDLT). This is not surprising given the concerns over abuse of the relief that were present in 1980. Given, however, that we have this condition, how many of the other requirements are really necessary to prevent the rules being used to facilitate tax avoidance?

No chargeable payments
It is the chargeable payments rules which typically prompt much angst at the time of contemplating a demerger as they can introduce uncertainty by reason of the need to consider potential future transactions. These rules require that the distribution must not form part of a scheme or arrangement the main purpose (or one of the main purposes) of which is the making of a chargeable payment. The definition of “chargeable payment” is wide and can
Exempt distributions: time for change?

be complex. It includes any payment (other than a qualifying distribution) by a company concerned in the exempt
distribution made (directly or indirectly) to a member of that company or to a member of any other company
concerned in the distribution in respect of their shares which either is not made for genuine commercial reasons or
forms part of a tax avoidance scheme.

Even if a demerger qualifies for exempt demerger relief when implemented, it will be necessary to monitor, and
perhaps to seek further clearance from HMRC in respect of, any chargeable payments made by the distributing
company, the demerging company and/or the company to which the demerging company’s shares are transferred
(or persons connected with them) so as to ensure that such payments made within five years of the demerger are
not converted into taxable income and that there is no revival of any de-grouping charge which would otherwise
have been triggered at the time of the demerger.

The chargeable payments provisions stem from a concern that the exempt demerger relief could be used to provide
shareholders with a cash payment (or other assets) in a manner that allowed shareholders to escape income tax
and the company to escape an ACT charge.

The problem in practice is that the provisions are widely drawn with no de minimis or statutory safe harbours.
The latter could usefully protect the types of payments that HMRC would expect to be made in the context of a
demerger or in the day-to-day running of a listed company.

Payments typically cleared with HMRC in advance include payments under the demerger documentation
and payments to be made in connection with employee share schemes, pension schemes and share buyback
programmes.

Seeking clearance for a wide range of commercial payments places a disproportionate compliance burden on the
company. It must also surely take up an unwarranted amount of HMRC’s resources.

No change of control
Exempt distribution treatment will be denied if one of the main purposes of the demerger is the acquisition by
any person (other than members of the distributing company) of control of the distributing company or any other
relevant company or any company belonging to the same group as one of these companies or the sale of a trade
after the distribution.

A demerger cannot therefore be implemented by way of an exempt distribution in preparation for a sale to a
third party or an IPO. This is particularly problematic in practice. A company considering the spin-off of a business
with an eye to a potential sale to a third party is likely to prefer a demerger structure which allows for a change in
control. This can be achieved with a reduction of capital demerger or a liquidation demerger. Unlike in the case of
a demerger structured as an exempt distribution, neither of these structures will, however, turn off de-grouping
charges when the demerging company leaves the existing group.

Companies are therefore required to choose between bringing themselves within the exempt distribution provisions
(which turns off de-grouping charges) but putting a third party sale on hold and pursuing an alternative structure
which will leave the group exposed to de-grouping charges.
CONCLUSIONS

There are numerous requirements to meet to take advantage of the exempt demerger relief. Not all of these would seem necessary to tackle tax avoidance. Some are outdated restrictions, derived from the historical context in which the relief was introduced.

Anecdotal evidence suggests that companies wishing to carry out commercially motivated demergers are put off from using the exempt distribution provisions to achieve the tax treatment their shareholders expect. For some, an anticipated change of control removes the exempt distribution option. For others, the EU residency criterion has necessitated a different structure.

Given that we have a relief specifically targeted at demergers, it seems odd that a company can be denied the opportunity to take advantage of this relief because it is unable to meet all the necessary conditions, yet that company can still achieve a tax-neutral demerger for shareholders using an alternative structure. The response may be that this very choice means that updating the exempt distribution provisions need not be a priority as groups are often able to find alternative solutions within the tax code. However, this should not be seen as a complete answer.

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