CHAPTER 24

SUBSTANTIAL SHAREHOLDING EXEMPTION

24.1 Introduction

Gains arising on disposals of qualifying shareholdings **are exempt** and **losses are not allowable.**

Other EU countries operate similar systems – Austria, Belgium, Denmark, Germany, Luxembourg, the Netherlands, Portugal and Spain currently exempt gains on all or some classes of substantial shareholding.

24.2 Outline of the relief

TCGA 1992, Sch 7AC

Gains are not chargeable and losses are not allowable where:

(i) an investing company;

(ii) which has held a substantial shareholding in an investee company (referred to by Sch 7AC TCGA 1992 as 'the company invested in') throughout a 12-month period;

(iii) disposes of any shares in the investee company.

There is no requirement for the proceeds from the sale of this shareholding to be used in any particular way.

24.3 The substantial shareholding requirement

The exemption is dependent on the investing company having held a substantial shareholding in the investee company throughout a 12-month period beginning no more than two years prior to the disposal. TCGA 1992, Sch 7AC Para 7

The investing company must hold at least 10% of the ordinary share capital of the investee company and must also be beneficially entitled to at least 10% of: TCGA 1992, Sch 7AC Para 8

(i) the profits available for distribution to equity holders; and

(ii) the assets available for distribution to equity holders on a winding up.

The definition of 'equity holder' and the determination of profits or assets available for distribution broadly follow the approach in Part 5 Ch 6 CTA 2010.

The purpose of the time limit referred to above is to allow subsequent disposals out of what was once a substantial shareholding to continue to qualify for exemption for a further 12 months, notwithstanding the fact that the 10% threshold may have ceased to be satisfied.

Illustration 1

Vaughan Ltd has owned 15% of Key Trading Ltd since 1998.

On 1 June 2010, Vaughan Ltd sold a 10% stake in the company at a profit. The gain on this disposal clearly qualifies for the substantial shareholding exemption.

However, some months later, the directors of Vaughan Ltd are considering the possibility of selling the remaining 5% shareholding.

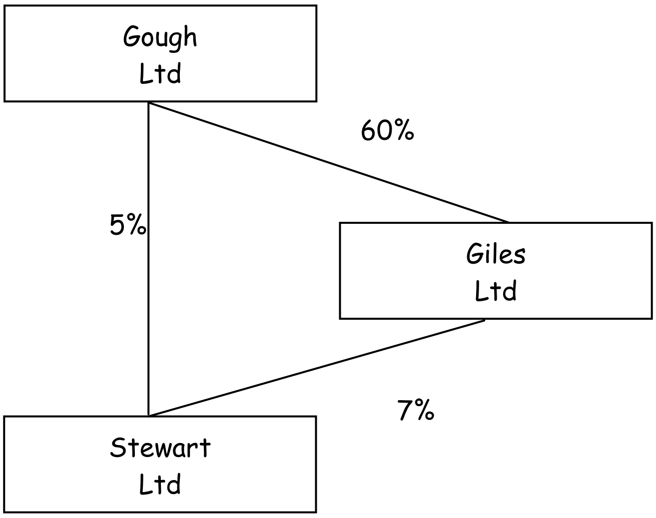
Even though the shares in Key Trading Ltd no longer constitute a substantial shareholding, the exemption is still available for disposals in the 12 months following 1 June 2010. Thus, if the second sale is also expected to realise a gain, it will be sensible for Vaughan Ltd to effect the disposal on or before 1 June 2011. However, if the value of Key Trading Ltd has recently declined such that a share sale would now crystallise a loss, the company should wait until after 1 June 2011 so that the loss will be allowable.

If a group's shareholding in the investee company is split between various group members, the shares can be aggregated in order to determine whether the substantial shareholding requirement is satisfied. For the purposes of these rules, a group comprises a principal company and its 51% subsidiaries – note that the s.170 TCGA 1992 definition of a group is used, the only difference being the substitution of '51%' for '75%'.

TCGA 1992, Sch 7AC Para 9

TCGA 1992, Sch 7AC Para 26

Illustration 2



In this diagram, Gough Ltd does have a substantial shareholding in Stewart Ltd (5% + 7% = 12%). Because Gough Ltd controls Giles Ltd the shares in Giles Ltd are treated as though they are held by Gough Ltd. Note that there is no need to work out an indirect interest.

24.4 Liquidations

When a company goes into liquidation, it loses beneficial ownership of its assets as a result of those assets being vested in the liquidator. However, the rules protect an investing company from this outcome as far as the substantial shareholding rules are concerned so that it can continue to satisfy the necessary conditions for exemption. TCGA 1992, Sch 7AC Para 16

TCGA 1992, Sch 7AC Para 18

24.5 Conditions for the investing company

The investing company must be either:

(i) a 'sole trading company'; or

(ii) a member of a 'trading group'

beginning with the start of the latest 12-month period in relation to which it passed the substantial shareholding test and ending with the time of the disposal.

It must also be a sole trading company or a member of a trading group immediately after the disposal.

A sole trading company means any trading company which is not a member of a group. 'Trading company' and 'trading group' are defined in much the same way as they are for entrepreneurs' relief purposes.

In looking at the activities of the members of a group the guidance states that "the activities of the members of a group are treated as one business. Intra-group activities are disregarded for the purpose of determining whether the group is a *trading group*. So, for example, where one group company lets a property to another group company, the letting activity would be disregarded for this purpose. However, this netting off approach does not extend to transactions with joint venture companies that are not members of the group. So, letting property to such a joint venture company would count as an activity of the lessor."

Companies with large bank balances can sometimes have a problem with the entrepreneurs' relief rules. It is possible that significant holdings of cash (perhaps generated by an earlier disposal of a subsidiary) will cause the same sort of difficulties with the substantial shareholding exemption.

You should refer to the HMRC guidance for further details on trading and investment activities.

Illustration 3

Poulter Ltd acquired 2,500 ordinary shares in Rose Ltd on 30 April 2002. This represented a 25% stake.

On 30 April 2010 Poulter Ltd sold 2,000 of these shares and 11 months later on 31 March 2011 the remaining 500 were disposed of.

In respect of the sale on 30 April 2010, Poulter Ltd must be a trading company or a member of a trading group for 12 months from 1 May 2009 until 30 April 2010.

However, for the sale on 31 March 2011, the qualifying period runs for 23 months from 1 May 2009 until 31 March 2011.

24.6 Conditions for the investee company

TCGA 1992, Sch 7AC Para 19

The investee company must have been a trading company or the holding company of a trading group throughout the period referred to in Illustration 3.

It must also be a trading company or the holding company of a trading group immediately after the disposal.

The guidance referred to above tells us that intra-subgroup activities are disregarded in the same way as intra-group activities when determining whether a subgroup is a *trading subgroup*. However, intra-group activities between a member of the subgroup and another group company that is not in the subgroup are not disregarded in considering the status of the subgroup.

However, where the investee company ceases to trade on being put into liquidation or following an intra-group transfer of its trade (so that it would no longer satisfy the test above), a special rule means any gain accruing to the investing company on a disposal of shares in the investee company continues to be exempt for a further two-year period. This is often called the second subsidiary exemption. TCGA 1992, Sch 7AC Para 3

The exemption applies where there was a time within the two years ending with the disposal when, if the investing company or a fellow group member had disposed of the shares, any gain arising would have been within the main exemption; and if, at the time of the disposal the target company did not meet the requirements of Para 19 Sch 7AC TCGA 1992 that it was trading, there was a time within the two years ending with the disposal when it was controlled by the investing company or persons connected with it, as defined in Para 3(2) Sch 7AC TCGA 1992.

The second subsidiary exemption does not apply if the investor is not a trading company after the disposal. Hence a holding company disposing of its last remaining trading subsidiary cannot qualify. However, it is available if the reason the investor does not qualify is because it has been wound up or dissolved; or it is about to be wound up or dissolved, and where the winding up or dissolution takes place as soon as reasonably practicable in the circumstances.

Also in this context, the anti-avoidance provision in Para 3(5) Sch 7AC TCGA 1992 should not be overlooked. It prevents the exemption above from applying to a gain (but not a loss) where value has been transferred into the investee company and a claim made for gift relief. Otherwise it would be possible to put a valuable asset into a company, which had ceased trading, under the protection of a s.165 TCGA 1992 holdover, dispose of the shares in that company and claim that the resulting gain was exempt under the substantial shareholding rules.

24.7 Holdover relief

Where a gift of shares is made to a company and holdover relief is claimed under s.165 TCGA 1992, it is not possible for the company subsequently to dispose of those shares with the benefit of the substantial shareholding exemption. An amount equal to the held over gain will still be chargeable. TCGA 1992, Sch 7AC Para 37

24.8 Investments in non-UK resident companies

The substantial shareholding exemption is not restricted to disposals of shares in UK-based companies. Gains arising on the sale of non-UK resident subsidiaries and other investments are also covered.

24.9 Intra-group transfers

The substantial shareholding exemption does not apply to s.171 transfers within a capital gains tax group. Effectively the s.171 provisions override the substantial shareholding rules where shares in trading companies are transferred between group companies. TCGA 1992, Sch 7AC Para 6

When an investing company acquires shares under a s.171 transfer and subsequently disposes of those shares to an unrelated company, the holding period is extended to include the period for which the transferor held those shares (and any period for which the transferor was treated as holding those shares as a result of the same provisions). TCGA 1992, Sch 7AC Para 10

The extended holding period also applies to transfers of shares that would fall within s.171, but for the provisions of s.171(3). This could include intra-group share exchanges, which are discussed in a little more detail below.

Illustration 4

Company A and Company B each acquire 5% of the ordinary share capital of Company D so that their combined holding is 10%. Company A and Company B are both wholly owned subsidiaries of Parent Co.

After six months, Company B transfers its 5% stake to Company C, a newly incorporated company that is also a wholly owned subsidiary of Parent Co.

Seven months later, Parent Co sells Company A (holding its stake in Company D) to Z Limited, a third party purchaser. At the same time, Company C sells its 5% stake in Company D to Z Limited. All of the companies are UK resident.

If we assume that all the relevant trading requirements are met and that the relevant percentages of ordinary share capital also reflect economic ownership, the analysis should be as follows:

The intra-group transfer of shares in Company D by Company B to Company C is not exempt. It remains a no gain/no loss transfer under s.171 TCGA 1992.

The disposal by Parent Co of shares in Company A is exempt from tax on capital gains under the new exemption.

The disposal by Company C of shares in Company D is also exempt from tax on capital gains under the new exemption. Company C is treated as having held the shares for 13 months, as its holding period is extended to include the holding period of Company B (because it acquired those shares under a no gain/no loss transfer from Company B). It is also treated as holding the shares held by Company A for 13 months because for part of that period it was a member of the same group as Company A and for the remainder of that period, Company B (the company from which it acquired the shares) was a member of the same group as Company A.

24.10 Degrouping charge

Where a degrouping charge arises under s.179 TCGA 1992 in relation to a holding of shares that, at the time of the company leaves the group, would qualify for the substantial shareholding exemption on an actual disposal of the shares, the substantial shareholding rules effectively override the s.179 provisions. TCGA 1992, Sch 7AC Para 38

This is achieved by treating the deemed acquisition and reacquisition of the shares as taking place at a time **immediately before the company leaves the group**, for a consideration equal to the market value at that time. This is in contrast to other deemed disposals under s.179 which are treated as taking place **immediately following the intra-group transfer** to which the degrouping charge relates. So, provided that the other conditions are satisfied at the time of the degrouping event, the substantial shareholding exemption will apply to the s.179 charge.

Furthermore, the base cost in the shares that are subject to the degrouping charge is uplifted (or reduced) to the market value of the shares at the time of the degrouping event. In effect, the company leaving the capital gains group is put in the same position, in terms of its carried-forward base cost, as if it had acquired the shares pursuant to a transaction to which the exemption applied at the time of the degrouping event.

24.11 Share exchanges

We have already seen that there are special rules where shares are exchanged for paper (shares/loan notes) as opposed to being sold for cash. The rules result in a no disposal fiction with the base cost of the old shares becoming the base cost of the new paper received.

How do these rules interact with the SSE rules?

The answer will depend upon whether the transaction takes place within or outside a capital gains group. We will look at the situation for a transaction wholly taking place within a capital gains group in the next section.

Illustration 5

X Ltd owns 35% of Z Ltd. Both companies are trading companies. Big plc wants to take over Z Ltd; Big plc offers all the shareholders in Z Ltd 3 Big plc shares for each Z Ltd share that they own. As a result of this offer X Ltd will receive 10,500 Big plc shares which have a market value of £126,000. X Ltd acquired the Z Ltd shares for £3,500 in January 1989. Following the share exchange there will be a total of 500,000 Big plc shares in issue.

Here we have a take over which falls within s135 TCGA 1992 and thus s127 TCGA 1992 will operate to say that the shares in Z Ltd will not be treated as being disposed of and the Big Plc shares will not be treated as being acquired rather that the Z Ltd and Big Plc shares will be treated as the same asset. In other words the Big Plc shares will "stand in the shoes" of the Z Ltd shares, taking on the base cost of the Z Ltd shares and the original acquisition date.

Thus X Ltd has a relief from tax on a chargeable gain at this point; however, this relief only applies until such time as the Big plc shares are sold. We also know that a disposal of the Z Ltd shares would qualify for SSE. So how does the no disposal fiction we have been looking at affect a claim for SSE?

We find the rule in para 4 Sch 7AC TCGA 1992 - it is not plainly written but essentially tells us that if we remove the no disposal fiction for a moment SSE will apply if the result is a capital disposal giving rise to a gain or loss.

Let's do that here - if s127 TCGA 1992 was not in point, would there be a chargeable disposal? The answer is yes as there is no other rule to prevent it in the above case.

As the answer is yes, we can use SSE.

This means that for X Ltd we don't use the paper for paper rules for the disposal of the Z Ltd shares, instead we say there has been a disposal and the resulting gain, in this case, is covered by SSE.

This means that X Ltd acquires the Big Plc shares on the day it receives them in exchange for the Z Ltd shares and that they have a base cost of £126,000. As X Ltd holds just over 2% of the Big Plc shares this holding will not qualify for SSE in the future.

24.12 Intra-group share exchanges

On an **intra-group** share exchange involving UK resident companies, the no gain, no loss provisions are not disapplied in relation to the assumed disposal. This is because when we remove the no disposal function of s.127 TCGA 1992, that transfer can be an intra-group transfer under s.171 TCGA 1992. We have already seen that the provisions of s. 171 TCGA 1992 overturn the SSE rules.

In relation to the actual disposal, this means that the SSE cannot apply. So the capital gains rollover provisions will apply to the share exchange in the normal way.

Illustration 6

Vendor Ltd is the holding company of a trading group. Vendor Ltd also holds 52% of the share capital in Talavera Ltd and this shareholding was bought for £300,000 on 1 December 1995. The shares in Talavera Ltd are to be transferred to a 100% subsidiary Palo Ltd in exchange for shares in Palo Ltd. At the time of the exchange the shares in Talavera Ltd have a market value of £450,000.

Subject to HMRC clearance, Vendor Ltd obtains share for share relief under s.135 TCGA 1992: Vendor Ltd is not treated as making a disposal of the shares in Talavera Ltd and the shares issued to it by Palo Ltd are treated as the same asset as the shares in Talavera Ltd.

Palo Ltd is treated as acquiring the shares in Talavera Ltd at their market value at the time of exchange.

As mentioned above, for the purposes of applying the substantial shareholding exemption on a subsequent disposal of the shares in Talavera Ltd, Palo Ltd will be able to look through the share exchange and treat its holding period as extended to include that of Vendor Ltd. It can also take into account holdings of companies that were in the same group as Vendor Ltd at the time. This is because the exchange is treated as a no gain, no loss transfer for the purposes of calculating holding periods.

Palo Ltd will be able to make a disposal immediately with the benefit of the exemption. It will make no difference if Palo Ltd is a newly incorporated company.

For the purpose of applying the new exemption on a subsequent disposal of shares in Palo Ltd by Vendor Ltd, the substantial shareholding requirement can be treated as met in relation to periods prior to the share exchange by reference to Vendor Ltd's holding of shares in Talavera Ltd.

24.13 Holdings in joint venture companies

TCGA 1992, Sch 7AC Para 23

For SSE purposes a company is a joint venture company only if:

(*a*) it is a trading company or the holding company of a trading group or trading sub-group; and

(*b*) 75% or more of the joint venture company's ordinary share capital is held by five or fewer persons. In determining how many persons hold the share capital, members of a group are treated as if they were a single company.

In the absence of special provisions, a group which holds one or more joint venture investments, where ownership is less than 51 per cent, might find that what would otherwise be a trading group is "tainted" by the holdings of the investment or investments. To prevent this there are provisions providing for "look through" of certain joint venture investments, treating the investing group and the joint venture company as if it were one.

For the look through to apply a company must have a "qualifying shareholding". This is a holding of at least 10% of the joint venture company's ordinary share capital. We can aggregate holdings of companies in a 51% group to meet this test.

The legislation sets out rules for disregarding and looking through shares where a company has a qualifying interest in a joint venture company as detailed below:

(*a*) Where a company, say C Ltd, has a qualifying shareholding in a joint venture company, in determining whether C Ltd is trading, the holding of shares in the joint venture company is disregarded and C Ltd is treated as carrying on an appropriate proportion of the activities of the joint venture company and its 51% subsidiaries (if any).

(*b*) Where C Ltd is a member of a group, to determine whether C Ltd is a member of a trading group, each member's shares in the joint venture company are disregarded and each member is treated as carrying on the appropriate proportion of the activities of the joint venture company and its subsidiaries.

(*c*) In determining whether a company, C Ltd, is the holding company of a trading group, the holdings of shares of C Ltd and any other "51% subsidiary" having a qualifying shareholding are disregarded, and each of those companies is treated as carrying on the appropriate proportion of the activities of the joint venture company and its subsidiaries.

It should be noted that these rules provide that the holding of shares in the joint venture company is disregarded but do not provide that income derived from the joint venture company must also be disregarded. If, for example, a company, C Ltd, lets property to a joint venture company, J Ltd, which is not a member of the same group, C Ltd's rental income will be taken into account in determining whether it is a trading company.

The disregard rules outlined at (*a*) to (*c*) above do not apply where the joint venture company is a member of the same group as the shareholding company concerned, in which case the normal intra-group rules apply).

Where the joint venture company is a holding company, the activities of the joint venture company and its "51% subsidiaries" are treated as a single business and any intra-group activities are disregarded

A clearance procedure is available.