CHAPTER 26

RECONSTRUCTIONS

26.1 Transfer of a trade between companies

In the first part of this chapter we will look at the rules which apply on the transfer of a trade from one company to another.

Assume we have two companies A Ltd and B Ltd. The trade of A Ltd is being transferred to B Ltd. This trade represents a collection of assets.

If A Ltd has no other trading activity this will result in the **cessation of A Ltd's trade.** This will bring to an end an accounting period within A Ltd.

In addition, if B Ltd has no other activity before the trade is transferred, B Ltd will start trading for the first time and the **commencement provisions** will apply. So B Ltd will start a brand new accounting period for corporation tax purposes.

The transfer of the trade will result in **balancing adjustments** being made on the company's plant and machinery and industrial buildings.

CAA 2001, s.266

If A Ltd **controls** B Ltd i.e. it owns more than half of the shares or votes, an **election may be made to avoid any balancing adjustments** by transferring the trade at the **tax written down value** of the assets. The election must be made within **two years** of the transfer of the trade.

If A Ltd has any trading losses, these **losses will remain with A Ltd.** A Ltd could make a **terminal loss claim** and carry the loss back three years against profits arising in the preceding three year period, going back to the later years before the earlier years.

The transfer of the trade will also result in **chargeable disposals**. However, any gains may be **rolled over** if A Ltd were to invest in other eligible assets within the time period one year before the transfer to three years after.

26.2 Successions

CTA 2010, s.938

We will now compare this with the rules that apply on a **succession to trade**.

For the succession rules to apply in the scenario we have been considering so far, A Ltd would need to own 75% of B Ltd.

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The rules would also apply if the two companies are under the **75% common ownership** of the same **person** - a person can in this situation either be a company or an individual.

The trade is transferred between the two companies in the usual way, however there are two main differences here:

Firstly, where the 75% relationship exists, plant and machinery will **automatically be transferred to B Ltd at tax written down value**. Where the transfer takes place part way through an AP, the allowances for that AP will be split between the two companies.

The second main difference relates to the **losses.** Where the 75% relationship exists, these are **transferred with the trade to B Ltd**. This prevents A Ltd from making a terminal loss claim and carrying back the loss three years.

These rules are **compulsory** and are given by the provisions of CTA 2010, s.944 and s.948.

The rules apply where the 75% relationship exists at some point in the one year before the transfer and at some point in the two years after.

CTA 2010, s.941

In addition to the succession rules applying, any assets transferred between A and B will be at **no gain no loss** assuming that **both companies are in the same capital gains group.** Note that to be in the same gains group both companies must be under 75% common ownership of the same **company,** not an individual.

Illustration 1

Barajas Ltd owns 100% of Heathrow Ltd and both companies have a March year end.

On 1 October 2010, Barajas Ltd transfers its trade to Heathrow Ltd. The TWDV of the pool at 1 April 2010 was £35,000

The writing down allowance for the year to 31 March 2011 will be:

£35,000 x 20% = 7,000

Barajas Ltd owns the trade for the first six months of the accounting period and will be entitled to 6/12ths of this writing down allowance. Heathrow Ltd owns the trade and the assets for the second six months of this accounting period and is also due 6/12ths of this writing down allowance.

To Barajas £7,000 x 6/12= £3,500
To Heathrow £7,000 x 6/12 = £3,500

Heathrow Ltd will take over the assets at a TWDV of £28,000 at 31 March 2011.

26.3 Restricting the loss transferred

CTA 2010, s.945

We will now look at the rules relating to **relevant liabilities** left behind in the transferor company.

S.945 states that **losses** of the predecessor being carried forward under s.944 **will not be available** to the successor **to the extent that liabilities retained exceed assets retained.**

Liabilities retained are all the **liabilities held** by the predecessor prior to the transfer that are **not transferred**. Certain liabilities do not count as retained liabilities, for instance loan stock, share capital and the company's share premium account.

CTA 2010, s.946

Assets retained are all **assets held** by the predecessor prior to the transfer which are **not transferred, plus the consideration for the transfer.**

CTA 2010, s.945(3)

In calculating the losses available to transfer, we value retained liabilities and assets at open market value, not at the balance sheet value.

CTA 2010, s.947(3)

CTA 2010, s.945(2)

Illustration 2

East Midlands owns 75% of Alicante Ltd. East Midlands Ltd transfers its trade to Alicante Ltd. There are losses brought forward of £900,000. The consideration for the transfer is £300,000. A building with a market value of £150,000 is not transferred. The company also retains relevant liabilities of £700,000.

		£
Losses to be transferred		900,000
Less:		
Relevant liabilities	700,000	
Relevant assets		
Building	(150,000)	
Consideration	(300,000)	
Excess liabilities		(250,000)
Losses available to Alicante		650,000

26.4 Other points regarding successions

Note that **s.938 only applies special rules for capital allowances and losses**. For all other purposes we have a cessation of trade.

This means that an **accounting period will come to an end** on the date the transferor ceases to carry on the trade and an accounting period will begin for the successor.

An **adjustment will be required re trading stock** whether or not the trade is transferred under s.938. The rules apply as follows:

If the stock is transferred to a **UK trader** who is **not connected** with the transferor company, the stock adjustment is based on the **price agreed** for that stock. However, a "just and reasonable apportionment" must be made **where the stock is transferred together with other assets**. This is not the imposition of a market value rule, but rather a **just and reasonable apportionment to stock** in these circumstances.

CTA 2009, s.162

Where the stock is transferred to a **connected UK party,** we must use **open market value** of that stock. However if the cost of that stock and the price received are both less than the market value of that stock, we can **elect** to use the **greater of cost or the price agreed**. This election must be submitted within two years of the end of the accounting period of the transferee.

CTA 2009, s.162

Where the stock is transferred to someone **other than a UK trader**, for instance an overseas company, or an employee who will not use the stock for future sales, then we have to use **market value** and no election to use anything else will be possible.

In any event the price treated as the disposal value under s.162 CTA 2009 will be the **purchase price deductible for the purchaser.**

The company will also be disposing of assets for capital gains purposes following normal capital gains rules.

Illustration 3

On cessation of trade, stock which cost £100,000 is transferred to a connected party for £120,000. The open market value of the stock is £150,000.

As both the cost and the price received are below the market value, an election is possible under s.167 where we elect to substitute the greater of the price agreed or the original cost in place of market value.

In this scenario it will be the price received, which is £120,000.

Example 1

Birmingham owns 100% of Malaga Ltd. Birmingham Ltd transfers its trade to Malaga Ltd when it has losses of £1,200,000. Malaga Ltd pays £250,000 for the trade.

Birmingham Ltd has:

Stock	100,000
Debtors	645,000
Cash	40,000
	£785,000

Creditors	250,000
Overdraft	500,000
P&L	25,000
Share capital	10,000
	£785,000

The cash, stock and overdraft are not transferred. Birmingham Ltd has received an offer of £120,000 for the stock

You are required to calculate how much of the loss will be available to Malaga Ltd.

26.5 Successions and case law

Although the legislation is anti avoidance legislation aimed primarily at additional loss relief being claimed by use of terminal loss claims and balancing allowances on capital items, it has been interpreted by many as a means of allowing losses to be bought.

Loss buying in this context will normally involve the hive down or across of a trade or part trade to a Newco by the vendor followed by a sale of the Newco to the purchaser. This may then be followed by a further transfer of the trade once Newco is owned by the purchaser.

This process will lead to many questions as to whether the requirements of s.938 have been met allowing the losses to be transferred, in particular has there been a succession? This will be particularly in point where a part of a trade is transferred.

S.951 will need to be considered as in addition to the basic rule in s.938, 939 and s.940 this allows the transfer of losses to take place where:

(i) A company ceases to carry on a trade and another begins to carry on the activities of that trade as part of its trade.

(ii) A company ceases to carry on part of a trade and another company begins to carry on the activities of that part as its trade.

(iii) A company ceases to carry on part of a trade and another company begins to carry on the activities of that part as part of its trade.

The legislation does not give any guidance as to what is to be regarded as part of a trade. It does not have to be a separately identified division or branch.

Case law gives us some guidance on how the legislation should be applied. The two leading cases are *Laycock v Freeman Hardy & Willis Ltd (FHW)* and *Falmer Jeans v Rodin.*

In the FHW case the company had two wholly owned subsidiaries that manufactured boots and shoes which were sold to FHW who sold them in their retail shops. FHW acquired the goodwill of its two subsidiary companies together with their assets and staff. They continued to manufacture the same class of boots and shoes from the same factories, which were then sold to the shops. The company kept separate accounting records for the two factories treating them as separate concerns.

It was stated that it was not necessary for the business to be identical in every respect after the succession. A successor may for example take over a business of fifty shops; he may choose to shut up some of those shops; he may make alterations to the goods that he sells; changes of that kind may or may not be substantial so it is difficult to say if a succession has taken place.

It was found that the trade previously carried on by the subsidiaries no longer existed following the transfer to FHW. The trade was identified as one of a manufacturing wholesaler. Although the manufacturing continued after the transfer the sale of the manufactured products, the wholesale ceased.

The above case was distinguished from the Falmer Jeans case.

In summary FM manufactured garments for FJ, a fellow subsidiary company. FJ sold jeans and other casual clothing. FM made the clothes from material supplied by FJ. The finished garments were not sold to FJ, rather FM's services were charged out to FJ at cost plus a margin. The margin represented a commercial return at all times.

FM started to make losses and on the advice of the accountants the trade and assets of FM were transferred to FJ. FJ kept separate accounts for the activities formerly carried on by FM.

It was stated that not all the activities of a trade need to be carried on following the transfer, but the activities must be sufficient for them to be treated as a separate trade.

It was held that FJ began to carry on the activities of FM, although FJ no longer made up cloth to the customers specifications but rather to its own specifications. It still continued to carry on the activities it had carried out prior to the merger, namely buying cloth and providing the specifications. FJ did not charge it customers separately for the manufacture of the garments, however its customers continued to pay for the manufacture of the garments in the purchase price they paid.

Where part of a trade is transferred or a trade is merged with an existing trade the principles of streamlining will be in point, which means that the successor is only allowed loss relief for the losses belonging to the trade or part- trade which was transferred from the predecessor and that the transferred losses are only allowed against the profits from the trade or part-trade acquired from the predecessor. However these streamlining rules only apply to the losses transferred under s.944 - they do not affect any existing losses in the successor nor do they affect losses incurred after the succession.

The legislation provides that any apportionment required to streamline profits and losses should be done on a basis that is just and reasonable.

26.6 Reconstructions involving issues of securities/transfer of a business

TCGA 1992, s.136 & s.139

Before looking at demergers we need to firstly reconsider the paper for paper rules. We have already looked at these rules in the context of takeovers. The rules are extended to deal with what we call reconstructions.

Firstly let's look at s136 TCGA 1992 which deals with reconstructions involving the issue of shares. This section applies where:

TCGA 1992, s.136

(*a*) an arrangement between a company ("company A") and:

- (i) the persons holding shares in or debentures of the company; or
- (ii) where there are different classes of shares in or debentures of the company, the persons holding any class of those shares or debentures

is entered into for the purposes of, or in connection with, a scheme of reconstruction, and:

(*b*) under the arrangement:

- (i) another company ("company B") issues shares or debentures to those persons in respect of and in proportion to (or as nearly as may be in proportion to) their relevant holdings in company A; and
- (ii) the shares in or debentures of company A comprised in relevant holdings are retained by those persons or are cancelled or otherwise extinguished.

Where this section applies:

(*a*) those persons are treated as exchanging their relevant holdings in company A for the shares or debentures held by them in consequence of the arrangement; and

(*b*) sections 127 to 131 (share reorganisations etc) apply with the necessary adaptations as if company A and company B were the same company and the exchange were a reorganisation of its share capital.

For this purpose shares in or debentures of company A comprised in relevant holdings that are retained are treated as if they had been cancelled and replaced by a new issue.

"Scheme of reconstruction" has the meaning given by Schedule 5AA TCGA 1992 which we will look at shortly.

Illustration 4

Payaso Ltd is the holding company of a group. It decides that it wishes to put in place a new holding company above itself. To do this the existing shares in Payaso Ltd are cancelled and reissued to Newco Ltd. Newco Ltd issues ordinary shares to the original holders of ordinary shares in Payaso Ltd in respect of and in proportion to their existing holdings.

The shareholders of Payaso Ltd will be covered by s137 TCGA 1992. As a result they are treated as not having disposed of their original shares in Payaso Ltd, and the shares they now hold in Newco Ltd are treated as the same asset as the shares in Payaso plc acquired at the same time and for the same cost as the original shares. In other words s127 TCGA 1992 applies the no disposal fiction.

References to shares or debentures being retained include their being retained with altered rights or in an altered form, whether as the result of reduction, consolidation, division or otherwise and any reference to a reorganisation of a company's share capital is to a reorganisation within the meaning of s126.

This section applies in relation to a company that has no share capital as if references to shares in or debentures of the company included any interests in the company possessed by members of the company.

For this section to apply the scheme of reconstruction must be for bona fide commercial reasons and not part of a tax avoidance scheme.

Now let's look at s139 TCGA 1992. This section deals with reconstructions involving the transfer of a business.

S139 TCGA 1992 applies where:

TCGA 1992, s.139

(*a*) any scheme of reconstruction involves the transfer of the whole or part of a company's business to another company; and

(*b*) the conditions below are met in relation to the assets included in the transfer; and

(*c*) the first-mentioned company receives no part of the consideration for the transfer (otherwise than by the other company taking over the whole or part of the liabilities of the business).

Where it is in point for the purposes of corporation tax on chargeable gains, the two companies are treated as if any assets included in the transfer were acquired by the one company from the other company for a consideration of such amount as would secure that on the disposal by way of transfer neither a gain nor a loss would accrue to the company making the disposal.

TCGA 1992, s.139 Para 1

The conditions referred to above in relation to the assets included in the transfer are:

(*a*) that the company acquiring the assets is resident in the United Kingdom at the time of the acquisition, or the assets are chargeable assets in relation to that company immediately after that time; and

(*b*) that the company from which the assets are acquired is resident in the United Kingdom at the time of the acquisition, or the assets are chargeable assets in relation to that company immediately before that time.

To use this section, the reconstruction must be carried out for bona fide commercial reasons and must not form part of a scheme or arrangements of which the main purpose, or one of the main purposes, is avoidance of liability to corporation tax, capital gains tax or income tax.

TCGA 1992, s.139 Para 5

A clearance procedure is available under s138 TCGA 1992.

"Scheme of reconstruction" has the same meaning as in s136 above - in other words we look again at Sch 5AA TCGA 1992.

TCGA 1992, s.139 Para 5

Illustration 5

Bootle Ltd has two trades. It transfers Trade 1 to Newco. In return Newco issues shares to the existing shareholders of Bootle Ltd.

Subject to meeting the requirements of Sch 5AA TCGA 1992 Bootle will be treated as having transferred any chargeable assets to Newco for a consideration that would result in neither a gain nor a loss arising in Bootle Ltd. Newco will be treated as having acquired the assets for the same sum.

As stated above, both s136 and s139 TCGA 1992 require us to look at Sch 5AA TCGA 1992 for the definition of a scheme of reconstruction which says:

1) The scheme involves the issue of ordinary share capital by the successor company to the holders of ordinary shares (or any one class of share) of another company and does not involve the issue of share capital to anyone else; and

2) all holders of shares or any class of shares have the same entitlement to shares in the successor;

and either:

3) substantially the whole of the business(es) carried on by the original company is (are) carried on by the successor; or

4) the scheme is carried out in pursuance of a compromise or arrangement under Part 26 of the Companies Act 2006.

Thus in Illustrations 4 and 5 above we need to meet both the above. Let's say in the case of Illustration 4 Payaso Ltd used Part 26 of the Companies Act 2006 and in Illustration 5 we meet condition 3 in respect of Trade 1 which was transferred.

With the above knowledge we are now ready to examine the question of demergers.

Basically demergers can be carried out in the following ways:

(i) The statutory route
(ii) Via liquidation
(iii) A Companies Act reconstruction

We will consider each, using the statutory route to do a full analysis and highlighting the differences where one of the other routes is used. Generally speaking routes (ii) and (iii) will be used when a company does not have sufficient distributable reserves to enable it to use the statutory demerger route.

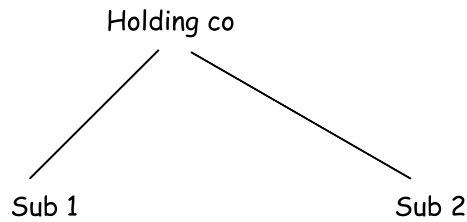
26.7 Statutory Demergers

CTA 2010, s.1075-1095

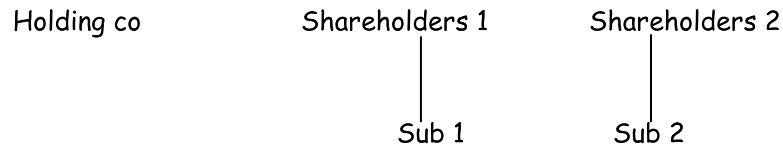
A group may have grown without much planning and a point may be reached where it is thought that the group could be run more efficiently by separating out various parts. There are many ways this can be achieved, however, the focus for us is on the tax impact of such a demerger.

Assume we have a holding company with two subsidiaries. We also have two separate groups of shareholders. The plan is to take the two subsidiaries out from under the holding company so that Subsidiary 1 is held by shareholder group 1 and Subsidiary 2 is held by shareholder group 2

Before

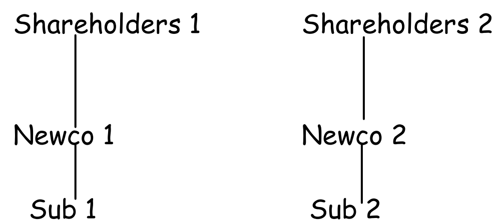


After



If we took the approach shown in the diagram above, we would have what is referred to as a "direct demerger" as the shareholders have had the shares in the subsidiaries directly transferred to them.

Alternatively the "**after**" position could look as follows



This is referred to as an "indirect demerger".

In either case, from a tax point of view, the transfer of the subsidiaries by the holding company will be a distribution of its assets to its shareholders under s.1000.

If the conditions for an **exempt demerger** are met, then **no distribution** will arise under s.1000.

CTA 2010, s.1075-1095

The special rules deal with direct demergers stating that transfers to all or some of the members of a company of shares in one or more 75% subsidiaries will not be a distribution.

CTA 2010, s.1076

The special rules also extend to indirect demergers by stating that the transfer by a company to one or more companies of the trade or shares of one or more companies which are its 75% subsidiary in return for the issue of shares by the transferee company to all or any of the members of the distributing company will not be a distribution.

CTA 2010, s.1077

The exemption applies to cross border demergers.

CTA 2010, s.1078

Each company must be resident in the EU at the time of the distribution. The distributing company must be either a holding company of a trading group or a trading company.

CTA 2010, s.1081

The **shares** issued by the transferee **must not be redeemable** and must represent the whole or substantially the whole of the issued share capital of the transferee.

CTA 2010, s.1082

The distribution must be made **wholly or mainly for the purpose of benefiting one or more of the trades and must not be part of a scheme for tax avoidance.**

CTA 2010, s.1081

The demerger **cannot** allow the acquisition by persons **other than the members** of the distributing company of control of the company or any company in the group. For these purposes a group is a 51% group.

In an indirect demerger the distributing company must only retain a minority interest in the trades or subsidiaries transferred.

CTA 2010, s.1083

If the relief is granted then there can be a claw-back should **a chargeable payment be made in the five years following the exempt distribution.**

CTA 2010, s.1086

The definition of a chargeable payment is very wide. It can cover any payment made by any of the companies involved in the demerger or any connected company and can include a person other than the company.

However they specifically **do not include distributions** including exempt distributions and payments made for **commercial reasons.**

CTA 2010, s.1088 & s.1089

Any charge as a result of a chargeable payment is assessed to corporation tax.

CTA 2010, s.1086(2)

It is possible to apply for **advance clearance** in writing prior to the demerger. HMRC have **30 days** to give their decision or call for further information.

CTA 2010, s.1091

The details of what is required in the application can be found in **SP 13/80**. Details need to be given of all the companies involved, copies of the P&L and Balance Sheet; details of the group structure before and after the distribution; the purpose of the distribution; full details of all shares to issued/changed, trades to be transferred; and any prior transactions.

SP 13/80

The clearance application has to state clearly that the requirements for an exempt distribution have been met and that the transaction does not form part of a scheme to avoid tax.

Following an exempt distribution or a chargeable payment, a **return** has to be made within thirty days giving full details. Where advance clearance was received details should be given and confirmation that full disclosure of all the circumstances has been made.

CTA 2010, s.1095

So far we have seen the exemption can apply to both direct and indirect demergers, so why do companies choose the extra step of inserting Newco for an indirect demerger?

The answer lies in considering the capital gains position of the various parties involved.

For a **direct demerger** the shareholders will receive shares in the subsidiaries in return for the shares that they held in the holding company thus they will have **a share for share exchange.**
The shares in the subsidiaries will stand in the shoes of the shares in the holding company. However the holding **company will be making a disposal for capital gains purposes** and this may give rise to a chargeable gain.

TCGA 1992, s.192

If an **indirect demerger** is used this position can be improved upon. Here the **shareholders still do not have a capital disposal** - they have received new shares as part of a reconstruction and thus the shares in Newco will stand in the shoes of the shares in the holding company. The holding **company** can look to s.139 TCGA 1992 for relief as **a reconstruction** as well.

Finally we need to consider **other possible impacts of the demerger:**

A degrouping charge will not arise where there is an exempt demerger unless there is a chargeable payment within 5 years of the demerger.

TCGA 1992, s.192

The shareholders are **not** treated as receiving a **capital distribution**.

The substantial shareholding rules will also need to be considered where the shares in question qualify for the substantial shareholding exemption.

26.8 Demerger via liquidation

Under s110 Insolvency Act 1986 the businesses and shareholding held by a company will be transferred to two or more new companies (Newcos) by the liquidator. The Newcos will issue shares to the original shareholders of the company that is in liquidation normally in proportion to their originally share holding in the liquidated company which is usually dissolved.

Thus this is very similar to the indirect demerger that we looked at above.

The demerger should fit the definition of a reconstruction thus s.136 and s.139 TCGA 1992 will be in point; clearances can be sought to verify this.

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As we will see in the liquidation's chapter there will not be a taxable income distribution under this method as CTA 2010 s.1000 does not apply if the company is in liquidation.

Note that if the liquidation route is used there is no relief from any charge arising as a result of transferring companies out of a CGT group under s.179 TCGA 1992.

26.9 Demerger using a Companies Act reconstruction

Under Part 26 CA 2006 a company can, with court approval, make a compromise or arrangement with its shareholders or creditors. Typically this would involve a reduction in the company's share capital; in return shareholder rights to a return of capital are reduced by the transfer of a business or shareholding to a new company (Newco).

Again this is similar to an indirect demerger in appearance. Sch 5AA in defining a reconstruction refers to Part 26 CA 2006, thus s.136 and s.139 TCGA 1992 should be in point, however clearance should be sought to confirm this.

Potentially there will be an income distribution however, so long as the market value of the transferred assets does not exceed the cancelled share capital (nominal value plus any premium) there will not be a taxable distribution.

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Answer 1

	£	£	£
Losses			1,200,000
Less			
Relevant liabilities		500,000	
Relevant assets			
Stock	120,000		
Cash	40,000		
Consideration	250,000		
		(410,000)	
			(90,000)
Losses transferred			1,110,000