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Categories:

Analysis Features CT

### KEY POINTS

- The need for simplification and the main proposals.
- An explanation of the new mechanism.
- Its interaction with existing rules.
- Why are there no matching changes to the rules for intangible assets?
- Some flexibility with just and reasonable adjustments.
- Have your voice heard by responding to the consultation document by 17 May 2010.

The anti-avoidance simplification review was announced at Budget 2007 to identify anti-avoidance legislation which could be simplified and made more effective without any adverse impact on revenues.

Various aspects of the rules on chargeable gains for groups of companies were identified as needing an overhaul and following a discussion document in July 2009, a consultation document was issued by HMRC/HM Treasury in February, with responses being required by 17 May 2010. The consultation document was followed up with a workshop with HMRC on 25 March.

The consultation document covers capital losses and changes of ownership, value shifting and depreciatory transactions, and degrouping charges. This article will be looking at the detail of the proposals for the degrouping charge; what's good, what's bad, and what still needs to be done.



### The need for simplification

The degrouping rules at TCGA 1992, s 179 are generally well understood, but have a number of defects. Not least the fact that they operate mechanistically and without any motive test.

This means that, as well as applying to tax avoidance schemes (the old envelope

trickq for example), the rules can, and frequently do, catch completely commercial transactions where no tax avoidance is intended and where, arguably, there is no policy reason for a tax charge. Furthermore, the rules could easily lead to economic double taxation.

## The proposals

In brief, the main proposals in the document are as follows.

- In most cases the degrouping charge will increase (or decrease) the gain in the vendor company, rather than creating a gain in the company being sold.
- Reliefs and exemptions applicable to share sales should therefore apply to the degrouping element of the gain, too.
- The new rules will permit companies to package up trades into new subsidiaries for sale, through an extension of the substantial shareholdings rules.
- There will also be a just and reasonable escape clause from the degrouping charge.
- The associated companies exception is being clarified following *Johnston Publishing (North) Ltd v HMRC* [2008] STC 3116.

## The new mechanism

Under the current rules, the degrouping charge arises within the company leaving the group, and is a gain on a deemed disposal of the assets transferred. So the reliefs and exemptions that apply to the share sale by the vendor will not apply to the deemed disposal and reacquisition under s 179.

Under the new rules, while the operation of the deemed disposal and reacquisition of the asset to which the degrouping charge applies is still the same, the mechanism of charge is entirely different.

On an actual disposal of the shares in a subsidiary, the degrouping gain will be treated as an increase in the consideration received by the vendor company, under the proposed new TCGA 1992, s 179(3C).

Where there is a degrouping loss, this will be treated as an increase in the allowable deductions against that consideration (under TCGA 1992, s 38).

The result is that the full charge arises on the company making the disposal, rather than there being a shareholder level charge on that company and a degrouping charge on the company that is leaving the group.

This removes the need for TCGA 1992, s 179A (which allows the degrouping charge or loss to be reallocated back to the vendor group). This provision will therefore be repealed.

Furthermore, since the adjustment would be to the consideration given for the sale of the shares by the vendor, the overall gain is a gain on the sale of the shares, even if there is a degrouping element to the gain.

So any the exemptions and reliefs that are available on a disposal of shares by a company, such as the reorganisation and reconstruction rules or the substantial

shareholdings exemption (SSE), will apply equally to the degrouping element of the gain.

**Example 1** in [this brief PowerPoint presentation](#) demonstrates how this should work. HoldCo owns three trading companies, T1, T2 and T3 and another company, EstateCo, which owns the group's real estate. A purchaser has offered to acquire T1, but also wants to purchase the property at which T1 carries on its trade.

Under the current rules, HoldCo would have to sell T1, which would be tax-free . assuming that all the other conditions are satisfied for the substantial shareholding exemption (SSE) to apply . and accept that there would be a gain on the sale of the property out of EstateCo.

Alternatively, the property could be transferred into T1 before sale, in which case a degrouping charge would arise in T1 when it was sold.

Under the new proposals, the property could be transferred to T1 before sale. On disposal of T1, the degrouping gain on the property would be treated as further consideration received by HoldCo for the disposal of the shares.

But if the disposal of the shares is exempt under the SSE, then the increase in the consideration would not matter.

So the new proposals would facilitate a trade sale of this nature, where not all of the trade's assets are in the trading company.

### **Interaction with reconstructions**

The application of the reconstruction rules to the degrouping element of these gains should be extremely helpful. Under the current rules, demergers by liquidation (under [Insolvency Act 1986, s 110](#)) or by return of capital must be carefully structured to ensure that there are no degrouping charges when the company being demerged leaves the parent group.

(This is not a problem for the so-called 'statutory demergers' within CTA 2010, s 1076 or s 1077 . previously [TA 1988, s 213\(3\)](#) . as there is a specific exemption from the degrouping charge at [TCGA 1992, s 192](#).)

Under the new proposals, however, I believe the intention is that the application of [TCGA 1992, s 139](#) to the demerger of the company leaving the group should extend to the degrouping element, too, so that degrouping charges will no longer be a problem for these demergers.

However, I am not sure whether the legislation, as currently drafted, achieves this aim. [Section 139](#) treats the gain on a disposal of the shares in the company that is demerged as being at no gain and no loss, so long as no consideration is actually given for those shares.

But the proposed new rule for degrouping is deemed to add consideration to the disposal proceeds, so that [139](#) would arguably no longer apply, as consideration would be deemed to be given as a result of any degrouping element. It is important that the draft legislation be clarified to put this matter beyond doubt.

## Interaction with SSE

A common problem arises where companies carry on several activities in a divisionalised structure, and a purchaser offers to buy one of the trades.

Currently, the vendor company either has to sell the assets, or it has to go through some major contortions to be able to sell the trade within a corporate shell, without generating a degrouping charge equivalent to having sold the assets in the first place.

Usually this is done by transferring all the other activities out of the target, which is then sold holding only the target trade. But this can create myriad commercial and legal problems, as well as potentially generating other tax charges, such as stamp duty land tax.

This has always seemed counter-intuitive, given that the stated intention of the SSE was to permit trading groups to churn their activities without hindrance from the tax code, so wouldn't it be far easier if the trade to be sold could be hived down to a subsidiary, which could be sold tax-free under the SSE, with no degrouping charge?

Under the new proposals, this should be possible. Because any degrouping charge is treated as additional consideration on the disposal of the subsidiary, the SSE would prima facie apply to the combined gain, so the degrouping problem goes away.

In most cases, of course, this is not the whole answer as the trade would be hived down to a new subsidiary set up specifically for the purpose.

So the new subsidiary would not have existed for 12 months, as required to satisfy the tests that its shares were held for 12 months by the vendor (or a fellow group member) or that it had been a trading company for 12 months before the disposal.

However, under the new proposals, the substantial shareholdings exemption would be modified, with a new TCGA 1992, Sch 7AC para 15A, to treat the new subsidiary's shares as having been held for a year, so long as the vendor group had previously carried on the trade through a qualifying company for at least a year.

And Sch 7AC para 19 would be modified to treat the new subsidiary as if it had been a trading company for the requisite 12-month period.

As shown in the first diagram of **Example 2**, TradeCo carries on three different trades, T1, T2 and T3. TradeCo wishes to sell trade T1.

Instead of transferring trades T2 and T3 to another company, with TradeCo and T1 then being sold, the new proposals will facilitate a reconstruction as shown in the after diagram where T1 has been hived down into a new subsidiary, NewCo, before that subsidiary is sold.

### But there's always a 'but'!

It all sounds great so far, doesn't it? A sensible approach to degrouping, with companies able to carry out commercial reconstructions and disposals without nonsensical tax charges. So what could possibly be the problem? In a word: intangibles!

The proposed new rules do not extend to the degrouping charges for chargeable intangible assets at CTA 2009, s 780 et seq.

So, while companies would be able to structure their reconstructions and disposals in a simpler fashion without worrying about chargeable gains, if they have chargeable intangible assets they will still have all the same old problems with exit charges and taxable credits.

Since the major asset of many businesses will be goodwill, the ability to package up trades for sale relying on the SSE will be materially restricted by the exit charges on any goodwill in the business, and the exemption from chargeable gains will be largely meaningless.

This is a bizarre inconsistency, which has been raised in discussions with HMRC.

However, the current indications are that the intangibles policy team at HMRC have no interest in mirroring the capital gains changes.

While I appreciate that the intangibles regime is an income regime, not capital, the fact is that it is deliberately structured to mirror the capital gains regime for companies in most major respects, so it is deeply disappointing that HMRC as a whole is allowing an opportunity for major simplification to slip away for no good reason.

To make similar changes to the intangibles rules is the only sensible approach to make this proposed reform of the degrouping charge actually useful in the majority of cases.

### **Multiple disposals and allocations**

In some circumstances, the disposal of a group subsidiary will mean sales of shares by more than one company within the group.

Where this happens, the proposals would permit the vendor group to allocate the gains or losses between the transferor companies in any proportions, so long as a joint election is made within two years of the end of the accounting period when the first relevant disposal occurs.

This draft provision appears to suggest that it would apply to the allocation of gains between group companies when they are all selling their shares in a group company at the same time, or to the allocation of gains where the disposal involves more than one disposal at different times, perhaps in different accounting periods.

On the subject of the allocation or reallocation of gains or losses, under the old rules, the vendor and purchaser groups could jointly elect that any degrouping gain be reallocated back to a company in the vendor group under TCGA 1992, s 179A.

The new proposals would provide that there will be no degrouping charge to reallocate, so s 179A will be repealed.

However, the facility for the vendor group to allocate gains (or losses) to other group companies will be retained by extending TCGA 1992, s 171A (actually by repealing s 171A(7), which prevents the reallocation of s 179 gains), so that the vendor group may reallocate the gain to any other company within the group.

## Non-disposal degrouping

Not all degrouping is caused by a disposal. If a third-party investor subscribes for shares in a group company sufficient to reduce the group holding below 75%, then the company ceases to be a member of the group and a degrouping charge may arise.

In these cases, the current basic rule remains unchanged, with the degrouping charge arising in the company that is degrouped, by virtue of the deemed disposal and reacquisition of the relevant assets.

In such cases, the proposed revision of s 171A (above) would appear to permit the reallocation of the gain within the vendor group. This is because the gain or loss on the deemed disposal and reacquisition under s 179(3) is deemed by s 179(4) to accrue before the company actually leaves the vendor group.

However, the proposed repeal of TCGA 1992, s 179B and TCGA 1992, Sch 7AB is more of a problem. These provisions allow any gains on the deemed disposal and reacquisition under s 179(3) to be the subject of a rollover relief claim on the acquisition of replacement business assets (TCGA 1992, s 152, s 153 and s 175).

The policy reason for the proposed repeal is that the new mechanism of charge at s 179(3C) means that there would not be a gain on a business asset to roll over, as the gain is added to the consideration for the share sale by the vendor.

But this new mechanism would not apply when a company has left a group without a disposal of shares.

In these cases, the current rules for a deemed disposal and reacquisition by the company leaving the group will continue to apply, so I believe that s 179B and Sch 7AB should be retained for cases where s 179(3) applies and the new mechanism described at s 179(3C) would not.

## Associated companies rule

In the *Johnston Publishing* decision, HMRC was vindicated in the view that the associated company exception only applied where the companies were associated both at the time of the original intra-group transfer and at the time of the subsequent disposal.

However, the decision and, in particular, some of the arguments put by counsel for each side in front of the Special Commissioner, meant that the scope of the associated companies rule at s 179(2) was not clear. The proposed new legislation clarifies the position, unfortunately making the rules more restrictive than they (apparently) are now.

The associated company exemption would now apply in either of two situations.

- The transferor and transferee are 75% subsidiaries and effective 51% subsidiaries of another company at the time of the original transfer and remain so until the time of the degrouping. This applies to sub-groups where there have been intra-subgroup transactions.
- One of the companies must be a 75% subsidiary and an effective 51% subsidiary

of the other at the time of the original transfer and must remain so at the time of the de-grouping.

The wording of these draft provisions is crucial, as it tells us that the companies must remain in the more or less same relationship to each other throughout the period starting with the original intra-group transfer and ending with the degrouping event.

So earlier planning, whereby a company would transfer an asset to a subsidiary but could, later on, be tacked under that subsidiary before a sale to prevent a s 179 charge arising, will no longer be valid.

This clarification of the exception from the degrouping charge is also applied in identical terms to the rules for chargeable intangible assets, in CTA 2009, Part 8.

The fact that the intangibles rules would be changed in this respect to mirror the chargeable gains legislation seems inconsistent with the approach mentioned previously, whereby there appears to be no policy appetite to amend those rules in line with the main change to the proposed degrouping charge changes, as discussed above.

### **‘Just and reasonable’ adjustments**

HMRC recognise that, however well-written the new rules are, there may be situations where an exit charge would be unfair or unreasonable, perhaps because such a charge would represent economic double taxation.

Rather than try to cover every possibility in the legislation, the proposals include a facility to claim a just and reasonable adjustment at new TCGA 1992, s 179ZA. This facility would apply to all degrouping charges, whether they arise through a disposal or some other degrouping.

The company or companies suffering an enhanced gain or an actual degrouping charge would be able to claim that the relevant gain should be reduced by a specified amount.

HMRC are then required to consider the share capital of the company being degrouped or of any associated company and the transactions whereby that company acquired the relevant assets.

These are the sorts of factors that would be taken into account in arriving at the computations of gain in any case, so it seems reasonable to look at these aspects.

It appears, however, from the current draft, that this is an exhaustive list and there is no discretion for HMRC to take into account any other factors.

I am not sure whether I would prefer the legislation to permit HMRC to consider all relevant aspects, or whether this might be a double-edged sword: in some cases, if HMRC were able to take other factors into account, a decision might go against the taxpayer that would otherwise have been in the taxpayer's favour.

**Example 3** illustrates how such an adjustment could work. HoldCo is a property investment group (where the substantial shareholding exemption would not be

available) and consists of four subsidiaries as shown in the diagram.

PropCo 1 owns a number of properties, including a factory transferred to it four years ago from PropCo 3. The transfer was at book value, which was £100,000, although the property was worth £250,000 at that time.

PropCo 1 is to be sold at an overall gain of £1 million. There would also be a degrouping gain of £150,000, as this is computed on the value of the property at the time of the original intra-group transfer.

Under the proposed new rules the degrouping gain would be added to the disposal proceeds to increase the total gain to £1,150,000. By the time of this disposal, the value of the property has fallen and it is now only worth £150,000.

Consequently, a claim might be made under TCGA 1992, s 179ZA to reduce the degrouping gain to £50,000, on the basis that it would be just and reasonable to do so. After all, if the property were sold directly, there would only be a £50,000 gain on today's process.

The consequence of a successful claim under s 179ZA would be a reduction in the gain accruing to the vendor. The draft legislation does not specify that this reduction be limited to the degrouping element of the gain, although it seems unlikely that a just and reasonable adjustment could ever exceed that amount.

The other element of the adjustment is that the deemed acquisition value of the asset (remember, s 179(3) still deems a disposal and reacquisition of the asset at market value) will be at market value less any adjustment made under s 179ZA.

Readers will also be relieved to note that this is a one-way only bet, and HMRC cannot invoke s 179ZA to make a just and reasonable adjustment in their favour.

Overall, I quite approve of the use of the just and reasonable test in a pro-taxpayer way, as most other instances of this test (such as in the value-shifting rules in TCGA 1992, s 30 et seq) only operate in HMRC's favour. Here, the proposed s 179ZA would give inspectors some discretion to eliminate a degrouping charge that was unnecessary and unfair.

### **A technical 'tweak'**

A technical amendment is proposed to deal with the fact that a degrouping charge can theoretically arise even if the transferor was not a member of the group when the asset was transferred to the transferee.

This rather anomalous result (because if the original transfer was not within a group, it is hard to see what abuse was being countered), is now being clarified by the proposed new legislation which requires the original transferee to be within the group at the time of the transfer before a degrouping charge can arise.

### **Comments**

First, what didn't happen? One slight negative note is that, despite substantial discussion as to whether the six-year rule in s 179 should be reduced to four, or even

three years, no such reduction is currently proposed. The reason given is the potential cost to the Exchequer, which is a difficult point to dispute in the current economic climate.

However, there are some welcome changes, simplifications and clarifications in the proposals, but for the glaring gap where the main proposals should be mirrored in the intangibles regime.

From a chargeable gains perspective it is clear that the consultation process has been pretty successful and, while it might appear a little churlish, I just find myself asking why it has taken so long for this legislation to be made fairer.

The consultation document refers to trying to enhance both fairness to taxpayers and the simplicity of the tax code. I see these two elements as being mutually antagonistic, because a simple tax code is likely to be unfair in many circumstances: its sheer simplicity means that there is no built-in discretion to make adjustments in what would otherwise be unfair cases.

Conversely, to build legislation that is fair to all parties could, in the extreme, be required to deal with every possible eventuality, which would make the legislation unacceptably long and, probably, unacceptably uncertain in its application.

I am happy to accept some trade-off for lack of simplicity to increase fairness, such as the proposed ~~just~~ and reasonable claims under s 179ZA, so long as HMRC operate the discretion fairly.

Overall, then, an ~~Act~~ to the capital gains policy team at HMRC and HM Treasury, at least in the area of the degrouping code; but so far a ~~£~~ minus for the intangible assets policy team.

As yet, we have no idea when these changes will be enacted (or even if they will be enacted).

All that HMRC were able to say, before the general election was announced, was that they hope to bring legislation forward in a Finance Bill later this year.

But the department cannot make any promises and if there is a new party in power after 6 May 2010, their plans may not include capital gains reform for companies.

However, these are important changes and will affect a large proportion of corporation tax payers, so please make your voices heard by responding to the consultation document by 17 May 2010.

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