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Statutory demergers

Speed read

Statutory demergers provide a relatively quick and simple method of separating a company's activities. They allow business owners the flexibility to separate their trading activities without crystallising a dry tax charge and avoid the cost of more complex demerger alternatives. There are 'direct' and 'indirect' statutory demergers, with strict conditions which mean that they will not be appropriate in some circumstances. They rely on specific provisions of CTA 2010 to effect an 'exempt distribution' in the hands of shareholders. Advance statutory clearance can be requested. The distributing company must make a return to HMRC within 30 days of making the distribution.

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Purpose and use of the statutory demerger provisions

In our experience, statutory demergers have historically not been very common for privately owned businesses. This is because many demergers in this market are carried out in contemplation of a sale, or to segregate businesses which are not trading. A statutory demerger cannot be used in these circumstances.

However, where the right fact pattern exists, a statutory demerger will likely be the simplest and least expensive route to segregate trading activities. In the current environment, where many owners are rethinking their businesses and operational structures, a refresher on these provisions is worthwhile.

Demergers are generally used as a means of separating the activities of a company or group where there are commercial reasons for doing so. We commonly see demergers where it is felt that different activities will develop better apart; where a person wants to buy part of a business (and other activities need to be removed pre-sale); and where shareholders wish to go their separate ways.

Although more complex methods of tax-efficient demerger are available (i.e. a capital reduction demerger or s 110 liquidation demerger), statutory demergers provide a relatively quick and simple method of separating a company's activities. They are another example of governments' wish to support businesses by removing tax as a barrier in their commercial development. Statutory demergers allow, in certain acceptable circumstances and alongside other such reliefs, business owners the flexibility to separate their trading activities without crystallising a dry tax charge.

The term 'statutory demerger' is perhaps a misnomer as, unlike in some other jurisdictions, there is no specific statutory process for carrying out demergers under UK statute. They rely on general provisions of the Companies Act to be effective: for example, by using distributions in specie and schemes of arrangement. The phrase 'statutory demerger' derives from the fact that there are statutory tax provisions in CTA 2010 Part 23 Chapter 5 that enable a demerger to be an 'exempt distribution' in the hands of shareholders, i.e. although it constitutes an income distribution in law, it does not do so for tax purposes.

Such statutory tax provisions have been included in the Taxes Acts for many decades, but they were largely rewritten into CTA 2010 during the tax law rewrite project.

How does the exemption work?

There are strictly two types of exemption, depending on how the demerger is structured, being the 'direct' and 'indirect' methods. Both constitute a distribution in law that would, without the exemption, be taxable in the hands of the shareholders as income taxed at the dividend rates. The exemptions simply mean that the shareholder is considered to have received a capital distribution, which should generally be tax-neutral for CGT purposes.

Although, technically, the exemption can apply to corporate shareholders, the general exemption for companies receiving distributions within CTA 2009 s 931A makes this a moot point. This article only considers non-corporate shareholders subject to income tax and CGT.

The conditions for the exemptions to apply include the following (see CTA 2010 ss 1081–1085):

- Statutory demergers can only be used to separate trading activities from each other, i.e. they cannot be used to separate an investment business from a trade.
- The distributing company can only retain a minor interest in the trade or company being distributed.
- The demerger must be made wholly or mainly for the purpose of benefiting some or all of the trades.
- The demerger must not be a scheme or arrangement the main purpose of which is:
  - the avoidance of tax;
  - the making of a chargeable payment;
  - the subsequent sale of a trade; or
  - the subsequent cessation of a trade.

Direct statutory demergers

A direct statutory demerger is simply a distribution in specie of one of the trading activities.

In practice, it is usually only used to distribute shares in a trading subsidiary where the substantial shareholdings exemption (SSE) will also exempt the distributing company from corporation tax on the capital gain arising on the disposal of those shares.

Shareholders

An income tax exemption is given by CTA 2010 s 1076.

As a consequence of the statutory demerger exemption from income tax, the distribution will strictly be a 'capital distribution' for the purposes of TCGA 1992. Under TCGA 1992 s 122, this will be a part-disposal of the shares in the distributing company, for which we might expect CGT to be due. However, where the assets distributed are shares in another company (which as noted above is usually the case), TCGA 1992 s 192 overrides s 122 to make the demerger tax-neutral for the shareholder.

Section 192 operates by invoking the conditions of TCGA 1992 s 127, such that there is deemed to be no disposal, and the shares in the distributing company (OldCo shares) and the shares in the company distributed (NewCo shares) together stand in the shoes of the OldCo shares.

This will mean that at some point the CGT base cost of the OldCo shares will need to be apportioned between the OldCo and NewCo shareholdings. For unlisted companies, this apportionment will be carried out on the first occasion of a disposal of shares from either holding (TCGA 1992 s 129), but for listed shares, the apportionment is based on comparative values on the date of the demerger (TCGA 1992 s 130).

Distributing company

As noted above, and as with any distribution in specie of a chargeable asset, the distributing company is making a disposal of those assets for capital gains purposes. Direct statutory demergers were consequently very rare until the introduction of SSE to exempt gains arising on the disposal of trading subsidiaries.

Indirect statutory demergers: trades transferred

Indirect statutory demergers are more complex, as they involve the transfer of the trading activities to a new company which issues shares to the shareholders as consideration. In the absence of any consideration otherwise given by the shareholders, this constitutes a distribution in law.

Shareholders

This distribution is exempt from income tax by virtue of CTA 2010 s 1077.

As a consequence of the statutory demerger exemption from income tax, the distribution will again strictly be a 'capital distribution' for the purposes of TCGA 1992, and therefore a part disposal of the shares in the distributing company (OldCo).

However, the transaction should form a scheme of reconstruction under TCGA 1992 Sch 5AA, in that chargeable assets are transferred to another company which issues shares to the shareholder in consideration.

The part-disposal of OldCo shares are received in consideration for shares in the acquiring company NewCo, and as this is under a scheme of reconstruction, TCGA 1992 s 136 then applies – and s 136 itself applies s 127, such that there is deemed to be no disposal, and the shares in OldCo and NewCo will together stand in the shoes of the OldCo shares.

There will be a requirement to apportion the CGT base cost of the OldCo shares on the same basis as described above.

Distributing and acquiring company

For the companies, reliefs available will depend on the nature of the assets transferred to NewCo.

As the assets are transferred by way of a scheme of reconstruction, chargeable assets are transferred at nil gain/nil loss (including shares in a subsidiary) under TCGA 1992 s 139.

Similarly, CTA 2009 s 818 applies to make a reconstruction involving a transfer of intangibles tax-neutral.

Stamp duty and SDLT reliefs may be available, providing the shareholdings of both companies mirror. Failing that, SDLT reconstruction relief could restrict SDLT payable by the acquiring company to 0.5% if the property is in use for the purposes of the trade transferred (provided the trade does not consist wholly or mainly of dealing in land). These SDLT reliefs apply only to land in England and Northern Ireland; however, there are similar provisions for land situated in Scotland and Wales.

Stock and capital allowances may require elections to enable assets to be transferred at NBV and TWDV respectively.

The transfer can also be VAT-neutral if it qualifies as a transfer of a going concern.

Comparing alternative types of demerger

	Statutory	Other
Can be used to split trading activities	Yes	Yes
Can be used to split non-trading/mixed activities	No	Yes
Can be implemented in contemplation of a sale	No	Yes
Can obtain advance clearance from HMRC	Yes	Yes
Relief from stamp duty/SDLT on implementation available	Yes	Yes
Ability to exempt de-grouping charges	Yes	Yes
Flexibility of implementation steps	Low	High
Complexity	Low to medium	Medium to high
Capital payment restrictions post demerger	Yes	No

This table gives a high-level comparison for quick reference only. Exemptions or reliefs may depend on specific facts and implementation steps.

Administration

Advance statutory clearance may be requested under CTA 2010 s 1091, to confirm that HMRC agrees that the distribution to the shareholder is exempt. This is arguably one of the most robust clearances that can be obtained, as it goes beyond confirming that the transaction is not for tax purposes, by actually confirming that the demerger will be tax-neutral for the shareholder, meaning less reliance will need to be made on tax opinion. For indirect demergers additional clearances for the wider tax reliefs are usually also included.

The distributing company must make a return to HMRC within 30 days of making the distribution, which must include details of why it is believed to be exempt. This is a necessary step, as without it HMRC may not otherwise be aware that such transactions have taken place, and therefore be unable to enquire into them. In practice, the existence of a positive advance clearance greatly simplifies this post-transaction reporting requirement.

Points to watch in practice

A statutory demerger may not be appropriate where:

- the activities to be separated are not both trades;
- there is a planned sale of one of the demerged trades: even if not blocked by the specific condition, this is likely to be seen as being for the purpose of benefiting the shareholder rather than the trade; or
- the company has insufficient reserves necessary to make a lawful distribution.

As with all types of demerger, where the proposal includes the transfer of a trade into a new company prior to distribution, appropriate de-grouping provisions must also be considered, including for capital gains, corporate intangibles and SDLT. In particular, corporate intangibles de-grouping may be in point if the trades are previously carried on from within a singleton company (due to the unavailability of SSE), and SDLT (or LBTT or LTT) de-grouping may be an issue where post-demerger shareholdings do not mirror.

Otherwise, it is important that the specific wording of all provisions is considered in the light of the proposed transaction. For example, although nothing prevents an indirect demerger into an existing company, s 1083(4)(b) requires that the shares issued by the transferee company 'constitute the whole or substantially the whole of its ordinary share capital.' The exemption will therefore be denied unless the new shares issued do not substantially outnumber the pre-existing shares.

The potential receipt of a capital payment within five years is often stated as an unquantifiable risk. This is actually very rare in practice, but it is nevertheless important to establish if the directors and shareholders may have such a future intention. If a capital payment is received, the capital payment will itself be subject to income tax (note: it is a common misconception that the capital payment causes the withdrawal of the exemption for the earlier distribution, which is not the case). Importantly, the sale of one of the demerged companies is not a chargeable payment, therefore a plan to sell within five years should not be an issue, providing no arrangements are in place for the sale when the demerger is carried out.

Recent developments

Since being rewritten in 2010, there have been no amendments to the statutory demerger provisions until this year. With effect from 11pm on 31 December 2020, the European Union (Withdrawal Agreement) Act 2020 expands the geographical scope to additionally include UK-resident companies (given that, post-Brexit, the requirement to be EU-tax resident would no longer have applied for UK companies).

Otherwise, the changes to the corporate intangibles de-grouping rules in FA 2019 (that extend the exceptions to de-grouping to transfers that would have qualified for SSE) have probably had the greatest impact on structuring statutory demergers. Under prior rules, it was really only possible to demerge goodwill by making the underlying assets of the trade the subject of an indirect demerger. Now, CTA 2009 s 782A prevents a corporate intangibles de-grouping event from arising where a trading group transfers a trade, with its goodwill, to a new subsidiary, and demerge the shares of that company – providing that SSE would have applied to the disposal of the shares by its parent (other than for the fact that it was overridden by the operation of s 139). Such an option remains unavailable when a trade is carried on by a singleton company.

Final thoughts

In the right circumstances, the statutory demerger provisions provide a tidy mechanism for companies and groups to demerge their trading activities through a simplified process, avoiding the cost of more complex demerger alternatives.

As for all demergers, robust implementation is key, and all relevant taxes and company law implications will need to be considered. ■

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- Investors' relief (N Jones & B Handley, 12.3.21)

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- Capital allowances: fixtures, s 198 elections
- Close companies: issues surrounding s 455
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