Three-way split

The shares of a trading company are owned by three individuals. One of them wishes to leave. The suggestion is that a new company is formed that will purchase the trade of the existing one and then equalise the remaining shareholdings.

A trading company is owned by three individuals in the proportions of: 40%, 40% and 20%. One of the 40% shareholders wishes to exit the company.

Because the conditions for a company buyback of own shares are not met (he has owned them for less than five years), the plan is for the remaining two shareholders to set up a new company which will buy out the exiting shareholder for cash.

The new company will offer the continuing shareholders a further issue of its own shares such that the trading company will become a wholly-owned subsidiary of the otherwise dormant new holding company.

Clearance is to be sought under TCGA 1992, s 138 in relation to the two remaining shareholders, that the provisions of TCGA 1992, s 135 will apply to the exchange of their shares in the trading company for the new issue of shares in the holding company.

Going forward, the two remaining company shareholders would like their shareholdings in the new company to be equalised whereas, at the moment, one shareholder’s interest in the trading company is twice that of the other’s.

Our question, therefore, is whether this can be achieved as part of the share exchange process without triggering any tax charges. If this can be done, we would appreciate readers’ comments as to how this can best be achieved.

Although we assume that a gift of shares between the two shareholders either before or after the share exchange would be eligible for holdover relief, our concern is that the recipient shareholder could face a charge on the value of the shares under the employment-related securities legislation.

Readers’ thoughts would be greatly appreciated on how best to achieve this corporate restructuring and the equalisation of the shareholdings.

Query 18,356 – Bemused

Reply from Pete Miller, The Miller Partnership
I think there is a fairly straightforward answer. Essentially, the two remaining shareholders should set up a NewCo and take 50% of the share capital each. NewCo then buys TradeCo and pays out cash or loan notes to the shareholders in proportion to their shareholdings.

To the extent that cash is paid out, a capital gain will arise for each shareholder of TradeCo, presumably chargeable at 10% because it is a trading company and entrepreneurs' relief may be available.

To the extent that NewCo issues loan notes, any gains should be held over (under TCGA 1992, s 135) until the loan notes are redeemed, at which point the gains come into charge.

Clearance that this treatment applies, on the basis that the transactions are carried out for genuine commercial reasons and not to avoid capital gains tax or corporation tax (TCGA 1992, s 137(1)), can be obtained from HMRC under TCGA 1992, s 138.

I would recommend that the exiting shareholder take cash, so that he obtains entrepreneurs' relief. If he takes loan notes, no entrepreneurs' relief would be available to him when the loan notes are redeemed because he will not be a shareholder of NewCo.

If cash flow requirements force him to take loan notes, he will want to make the appropriate election under TCGA 1992, s 169Q or s 169R to disapply the reorganisation provisions.

The other two shareholders will need to be careful of the transactions in securities legislation, which HMRC are likely to apply if they also get a material amount of cash out of the transaction and TradeCo has distributable reserves.

Without going into detail, HMRC might see the transactions as avoiding income tax and try to charge additional tax under ITA 2007, s 698.

It may be necessary to structure their consideration for the sale of TradeCo to NewCo as long-term loan notes, to prevent HMRC's objections. Once again, pre-transaction clearance can be sought, under ITA 2007, s 701.

In terms of the technical issues raised by the query, I have some observations.

First, it is theoretically possible to set up NewCo with just a few shares and then sell TradeCo to it for an issue of an equal number of shares to each remaining shareholder, so that they end up with half each.

My concern is that HMRC would see this as a value shift under TCGA 1992, s 29, although I have never seen HMRC take the point on a reorganisation or a reconstruction, even in extreme cases. However, it is certainly a risk that I would prefer to avoid.

Second, the unequal consideration in such a structure could also fall foul of the employment-related securities legislation because one shareholder might be seen as receiving more than market value for their shares.

Finally, the other point raised is that the employment-related securities legislation might apply to the gift of shares. I have grappled with this a number of times because it is entirely illogical that there is a capital gains holdover, but an income tax charge.

I think it demonstrates a lack of internal connectivity within the tax system. Anecdotally, I heard that when the employment-related securities legislation was put in place, the policy people did not confer with their capital gains tax colleagues, which is why there is a mismatch between the two regimes.
Reply from Thicket

The short answer is that the share for share exchange rules might be used to assist in this issue. I think the key point is to establish the objective of the shareholders, particularly the 40% shareholder who will be reducing his holding to equalise, let us call him X.

Where company A (NewCo) issues shares or securities in exchange for shares or securities in another company B (Target), and providing certain conditions are met, companies A and B are treated as the same company.

The transaction is treated as a reorganisation and the new shares or debentures replace the old shares for tax purposes. NewCo will acquire all the shares in Target, and that will satisfy the condition in TCGA 1992, s 135(2)(a) that NewCo will acquire, as a result of the exchange, at least a quarter of the ordinary shares in Target.

We are not told a great deal about the proposals to reorganise the shareholdings. Presumably the exiting shareholder will be paid in cash, or a mixture of cash and redeemable loan notes in NewCo.

He will be charged to capital gains tax to the extent that he receives cash and, generally, will be charged to capital gains tax when the loan notes are encashed.

Once X’s objectives are established, his position will need to be considered. If he takes cash for some of his shares, the share exchange rules will not apply and capital gains tax will arise.

He might want to accept enough ordinary shares in NewCo so that he holds the desired 50%, and debentures or perhaps fixed-rate preference shares for the remainder of his target company shares. To the extent that he accepts shares or debentures, there will be no immediate tax charge.

Clearance should be obtained under TCGA 1992, s 138 and there will need to be a good commercial reason for the transaction. The reasons are not given to us, but it may be part of succession planning to introduce new management and share ownership.

Consideration should be given to applying for clearance under the “transactions in securities” anti-avoidance rules.

I agree that there are issues with a “gift” of shares at a later date. There is an exception to the employment-related securities rules if shares are acquired as a result of personal relationships – easily demonstrated in the case of a gift between family members.

I have had success in arguing this in the case of a gift of shares to an unrelated employee who was a natural successor, but it is not without difficulty.

Closer look... TCGA 1992, s 29 and value shifting

The replies raise the issue of the possible application of the transfer of value rules in TCGA 1992, s 29. Simon’s Taxes explains that s 29 deems a disposal to take place where transactions result in value passing out of some assets into others. Most importantly, this may happen in relation to the control of a company by controlling shareholders.

“If a person controls a company and exercises his control, eg by alteration of rights or otherwise, in such a way that the value passes out of shares in the company which are owned by him or a person connected with him, or out of rights over the company
exercisable by him or such a connected person, and passes into other shares in, or rights over, the company, there will be a disposal of the shares by the owner or of the rights by the person who could exercise them.”

The same rules apply where two or more persons control a company and jointly allow value to pass out of their shares. In *Floor v Davis* [1979] STC 379, the rule applied where value left the shares of three shareholders as a result of a winding-up resolution on which only one of them voted. It was held that all three exercised collective control because the resolution was an integral part of a scheme arranged between them.”

For most purposes, the consideration deemed to be received for the disposal under s 29(2) is “the consideration that would have been received from an unconnected person acting at arm’s length from the controlling shareholder”.

HMRC’s *Capital Gains Manual* has information at CG58850 et seq.

CG58855 notes that “a minority holding of shares will generally be worth less per share than a majority holding. Value may pass from a majority holding to one or more minority holdings. The increase in the value of the minority holding or holdings may be less than the decrease in the value of the majority holding. The aim of the legislation is to tax the amount of value which actually passes into the transferee holdings, not the amount which passes from the transferor. So in these cases the disposal proceeds assessable on the transferor are limited to the increase in value received by the transferees.”

**Source URL:** [http://www.taxation.co.uk/taxation/Articles/2014/03/25/322391/three-way-split](http://www.taxation.co.uk/taxation/Articles/2014/03/25/322391/three-way-split)