A number of different types of corporate reconstruction have been made simpler by the changes to the rules for reductions of capital by private companies in the new Companies Act 2006. Under the old company legislation, a company could only reduce its capital by way of a court order, which required both a barrister to prepare the paperwork plus a court fee and an appearance in front of a commercial judge. This tended to be both time-consuming and expensive, both of which were major barriers to private companies carrying out such transactions. Under the new rules, section 641 Companies Act 2006 allows a private company to reduce its share capital by a special resolution supported by a solvency statement. This requires the directors of the company stating that each director considers the company currently able to pay its debts and able to pay any debts that will become due during the 12 months following the reduction of capital. In the alternative, if the company will be wound up within 12 months of the reduction of capital, the statement must state that the company will be able to pay its debts during the winding-up process. The statement of solvency must be made no more than 15 days before the special resolution for the reduction of capital.

While this process is clearly much simpler than the previous process (note that public companies still require a court order to reduce their capital), the obligations under a statement of solvency are not to be taken lightly. Indeed, if the directors make a statement of solvency without reasonable grounds for so doing, the directors can be fined or even imprisoned for up to 2 years! On that basis, not only should the directors inspect the company’s affairs very carefully, themselves, but I would recommend that they ask for support from their accountants in this matter. The support does not have to go as far as an effective audit of the company, as was necessary under the old "whitewash" procedures for financial assistance purposes, but a report from the accountants would give the directors further comfort as to the company’s favourable solvency position.

Once a company has established the possibility that it might reduce its share capital, what can be done with this new process?

**Return Of Capital To Shareholders**

I was approached by a company that had some GBP5m of share capital, which they had subscribed to
support bank lending of about GBP8m. The bank loan is long repaid and the shareholders wanted to take out the money that they had originally subscribed into the company as they did not need such a large capital base.

Technically, this would also be more tax efficient than a dividend. The company could have paid dividends of over GBP3m, which would have been taxed in the hands of the shareholders at 30.55 percent. Conversely, a reduction of capital, whereby all but GBP100,000 of the share capital is returned to the shareholders would, at worst, have generated a capital gain chargeable at 10 percent (as this was a trading company). And the capital gain might well have been virtually nothing (in effect, returning GBP4.9m of capital that had been subscribed at an initial cost of GBP4.9m, so no gain).

HMRC does not like companies returning capital to shareholders, particularly if the company has distributable reserves at the same time. In essence, HMRC's view is that the reduction of capital and returning that capital to shareholders is avoidance of income tax as, to the extent the company has distributable reserves, HMRC considers that those should be distributed to the shareholders, first. To be frank, my view is that this is HMRC stretching the concept of avoidance of tax far further than is reasonable. Putting the matter very simply, why should a shareholder take out distributable profits from a company, which would be taxable at up to 30.56 percent, when that shareholder can just as easily extract surplus capital from the company with, potentially, no tax charge at all?

Putting this another way, in most cases, tax avoidance requires some kind of uncommercial and usually relatively complex structures or transactions. In the case of a reduction of capital, we have a simple choice between a relatively straightforward process of paying a dividend and a similarly straightforward process of paying back some of the company's capital. Outside the scope of the general anti-abuse rule (GAAR), it is generally considered that it is still acceptable for taxpayers to plan their tax affairs in a tax-efficient way, and that this would not normally be considered to be tax avoidance. This is backed up in general terms by cases such as Duke of Westminster v CIR (19 TC 490), as well as by cases like CIR v Brebner (43 TC 705), which is a case specifically concerned with the transactions in securities legislation, albeit in its pre-FA 2010 form. Lord Upjohn in the House of Lords said: "When the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out – one by paying the maximum amount of tax, the other by paying no, or much less, tax – it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course one of the main objects is ... avoidance of tax." This is clearly statutory authority for my proposition, that reducing a company's capital and returning that capital to shareholders is not avoidance of income tax, regardless of whether the company has distributable reserves.
There is a further, technical reason why the transactions in securities rules cannot apply to a reduction of capital in this way. Specifically, the legislation states that the rules do not apply to sums or assets representing the return of sums paid by subscribers on the issue of securities (section 685(6) ITA 2007). Although this has been referred to in old cases as referring only to foreign companies, in the more recent case of Marcus Bamberg (TC00618) it was confirmed that this also refers to the return of capital by a UK entity.

Overall, therefore, in the context of the transactions in securities rules, we conclude that the legislation should not necessarily apply to a reduction of capital by a company using the new Companies Act legislation. In summary, the reasons are that this is simply not avoidance of income tax, that the jurisprudence supports the right to reduce capital rather than pay a dividend and that, in any case, the wording of the legislation suggests that the transactions in securities rules do not apply to such transactions.

Of course, the reduction of capital route can still be used in cases where the shareholder is clearly not avoiding UK income tax. Examples would include non-UK resident individuals, who cannot be avoiding UK income tax because they would not be subject to it, and corporate shareholders who would not, generally, be chargeable to corporation tax on dividends received. Finally, one assumes there are also cases where, if there is a sufficiently strong commercial reason for reducing a company’s capital, HMRC would accept that avoidance of income tax was not, in any case, one of the main purposes of the transaction.

**Share Exchanges And Stamp Duty**

In another, less contentious, scenario, our client family owned a number of companies that had grown up over the 35 or so years that the family business had been carried on. Each of these companies was held by different combinations of the family members (mother, son, daughter and family trust) and the decision had been made to put all of the companies under a single holding company, for ease of management, among other reasons. This was a fairly straightforward transaction of share-for-share exchange, for which clearance can be obtained from HMRC that there should be no capital gains tax charge.

However, a share exchange of this nature would also carry a substantial stamp duty charge on transferring the shares of the various companies under the new holding company. So, instead, we structured the transaction as a reduction of capital by each company, followed by the issue of new shares to the holding company, which in turn issued shares to the shareholders. Neither the reduction of capital nor the issue of new shares carries a stamp duty charge, and HMRC clearance for the transactions was also obtained. We have now carried out a number of similar transactions, saving clients many thousands of pounds of stamp duty.

The main point here is that the requirements for the treatment of the transaction as a scheme of reconstruction include that the transactions be carried
out for bona fide commercial reasons and are not for the avoidance of capital gains tax or corporation tax (section 137(1) TCGA 1992). The example has already highlighted the commercial reasons for carrying out the transactions. When HMRC asked why the transaction was carried out this way, rather than by exchange, we explained that we did not wish to incur a stamp duty charge. We do not consider that structuring the transaction this way is in any way avoidance of stamp duty: as with the returning of capital to shareholders, above, we consider that structuring a transaction slightly differently in order to ensure that a particular tax charge does not arise should not, as a matter of course, be assumed to be avoidance. In any case, since the treatment of a transaction as a scheme of reconstruction only requires that it not be carried out with a view to avoiding corporation tax or capital gains tax, even if this were avoidance of stamp duty, HMRC clearance have to be forthcoming.

On a technical note, the new Companies Act rules do not allow a company to reduce its capital to nil, even for an instant. So in the transaction described, each company firstly reduced its capital by 50 percent and issued new shares to the holding company using the reserve so created. The companies then reduced the rest of the original capital. For commercial reasons, they then issued further new shares to the new holding company, although this was not specifically necessary for tax purposes.

In analysing whether the transactions constituted a scheme of reconstruction under Schedule 5AA TCGA 1992, we see that the new holding company then issued shares to the shareholders of the original companies, pro rata to their original shareholdings in each case, and not to any other person. This satisfies the first and second conditions of the Schedule (paragraphs 3 and 4). The holding company now holds all of the companies that were originally held directly by the various family shareholders, so it can be said that the businesses carried on by each of those companies can now be seen as being carried on by the holding company (as Schedule 5AA allows us to look through the corporate veil), thus satisfying the third condition at paragraph 4 of the Schedule. This means that the transaction qualifies as a scheme of reconstruction.

As a result, the shareholders obtain relief from taxation under section 136 TCGA which, operating very similarly to section 135, treats the transaction as if the new holding company and each of the original companies were one single company reorganising its share capital, so that the shareholders are treated as not having disposed of their shares in the individual companies nor as having acquired the shares in the holding company. Instead, the holding company shares are treated as if they were the same shares acquired at the same time and for the same price as each original shareholding.

**Group Reconstructions**

We are often asked to advise on the best way to split a company or group between different shareholder groups. In many cases, particularly where investment companies are involved, rather than training
companies, it was necessary to carry out the separation of activities by way of a "liquidation reconstruction." This was often not a commercially desirable approach, because no one likes to liquidate a company if it can be avoided, and the liquidation process itself can be quite pricey.

Many of these transactions can now be efficiently structured by using a reduction of capital, instead, which avoids the need for a liquidation and the additional fees. A number of cases we have dealt with involved the splitting of property portfolio companies, where the reduction of capital approach also ensures that no charge arises to stamp duty land tax.

Consider the example where a single company with a property rental business and a large number of properties is to be split between two groups of shareholders. Since this is not a trading company, the so-called statutory demerger route is not available to us, so we must look to alternatives. Typically, the steps for a liquidation reconstruction would be as follows:

- Insert new Topco by a share-to-share exchange
- Reorganize the Topco shares into A and B shares giving A shareholders the rights over the A portfolio and B shareholders the rights over the B portfolio
- Transfer, say, the A portfolio up to Topco
- Liquidate Topco
- The liquidator transfers the A portfolio to a NewCo A which issues shares to the A shareholders, and transfers the original company, holding the B portfolio, to a NewCo B which would issue shares to the holders of the B shares (under section 110 Insolvency Act 1986).

As noted, people do not like to liquidate a company, even when it is a solvent company carrying out a normal reconstruction transaction. Furthermore, the transfer of the A portfolio from the Holdco to NewCo A carries a charge to SDLT at up to 5 percent on the value of the properties concerned. Finally, in addition to the costs of both tax and accountancy advice, an insolvency practitioner is required to carry out the liquidation.

Using a corporate reduction of capital, these problems all go away. The steps would be:

- Insert new Topco by a share-to-share exchange
- Reorganize the Topco shares into A and B shares giving A shareholders the rights over the A portfolio and B shareholders the rights over the B portfolio
- Transfer, say, the A portfolio up to Topco, preferably by distribution in specie
- Topco then resolves to reduce its capital by cancelling the B shares
- In consideration of this, the shares of the original company are transferred to a NewCo B which issues shares to the B shareholders.

This leaves a very similar situation to that following the liquidation reconstruction. However, there has not been any liquidation and nor have any properties been transferred from one company to another by a transaction carrying SDLT.

The SDLT analysis for the transfer of the A portfolio to TopCo is that there is a specific exemption for a transfer by distribution (section 54 FA 2003). If a distribution in specie is not possible, the transfer
can take advantage of the SDLT group relief (Part 1 Schedule 7 FA 2003), so long as there is not a change of control of the Holdco within 3 years (paragraph 4ZA(4) Schedule 7 FA 2003). This is a slightly more complex point than the mere distribution in specie, which is why the distribution is the preferable approach where possible.

Finally, of course, there is no need to engage an insolvency practitioner so there should be an overall reduction of fees.

These transactions qualify as schemes of reconstruction under Schedule 5AA TCGA, so that the shareholders can take advantage of the reliefs under section 136 TCGA, as in the previous transactions. Once again, we have obtained HMRC clearance in advance that these are commercial transactions and there is no avoidance of corporation tax or capital gains tax.

The transfer of the original company from Topco to NewCo B is also part of the scheme of reconstruction. Section 139 TCGA applies to prevent any gain arising in Topco when the shares are transferred. The conditions for this provision to apply are that the transaction is carried out for bona fide commercial purposes and not to avoid income tax, corporation tax or capital gains tax. Once again, HMRC clearance has been obtained under this provision, as there is no avoidance of income tax, corporation tax or capital gains tax.

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