Breaking Up's Not Hard To Do!

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In this article, we will give a high level overview of what a demerger is and how to carry one out in the United Kingdom. All references are to the Taxation of Chargeable Gains Act 1992, unless otherwise stated.

What Is A Demerger?

There is no statutory definition of a demerger, but the first feature of a demerger is that a business or businesses carried on by a simple company or by a group of companies is/are split up so that the business or different parts of it are now carried out by different companies or groups, under common ownership, but no longer in the same group. For example, a common demerger for a small company is for an owner manager to form separate companies holding the trading activities and the business property, where they might previously have been in a single company. Larger groups might want to hive off non-core businesses as they mature.

The second element of a demerger is that the shareholders before the demerger are also the shareholders afterward. In the first example above, the shareholders of the original trading company before the demerger will be the shareholders of two companies afterwards, one with the property and the other with the trade (see Diagram A).

Diagram A - demerger
This principle can also be satisfied if it is intended to segregate or partition the shareholders (see Diagram B).

**Diagram B - demerger and partition**

The different activities are divided into companies owned by different shareholders, but we still have the same shareholders before and after the transaction.

Finally, a demerger does not involve any money changing hands. Instead, a demerger usually uses a scheme of reconstruction involving the transfer of assets from one company to another and benefiting from the tax reliefs relating to such schemes of reconstruction.

**Mechanisms**

The main principles of the transaction are that assets of a company are transferred to a new company owned by some or all of the original shareholders. No consideration passes between the companies, as noted above, but the company receiving the assets will issue shares to its shareholder as part of the transaction. In Diagram B, for example, the B Business is transferred to B Ltd, and B Ltd issues shares to the B shareholder.

Note, by the way, that the businesses in question might also be shares of subsidiaries, so that this could be the division of a group, rather than of a singleton company.

One of the fundamental issues here is that of UK company law. A company is not entitled to transfer its assets for no consideration, so we need to find a company law mechanism that allows us to do so. The mechanisms generally used are:
- A distribution *in specie*
- A liquidation, and
- A reduction of capital.

Let us look, briefly, at how each of these would work in turn, by reference to Diagram B.

**Distribution**

The aim is to transfer assets, *i.e.*, the B Business, from A Ltd to B Ltd. The first step would be to reorganize the share capital of A Ltd so that A now holds A shares which have rights over the A Business and nothing else, and B has rights over the B Business and nothing else. This is a reorganization of share capital to which Section 127 should apply, so neither shareholder is treated as having disposed of his original shareholding or as having acquired any new shares.

The next step is to declare a distribution *in specie* on the B shares of the B Business — in other words, to distribute the B Business to B. In order for the transaction to constitute a scheme of reconstruction, the business cannot be transferred directly. Instead, it would be directed that the assets of the B Business be transferred to B Ltd, in return for which the B Business issues shares to Party B, so satisfying the distribution.

**Tax Reliefs**

What reliefs are available? The demerger step should qualify as a scheme of reconstruction (Schedule 5AA), and there are three conditions to be satisfied for that to be the case:

1. There must be an issue of ordinary share capital by a successor company, B Ltd, to a shareholder of an original company, *i.e.*, to Party B as a shareholder of A Ltd.
2. The right to the newly issued shares is related to the shareholding in the original company. In our case, Party B holds all of the B shares of A Ltd and they are therefore the only person issued shares by B Ltd.
3. The business being carried on by the original company, A Ltd, must be carried on after the transaction by two (or more) successor companies, such as A Ltd and B Ltd, which is achieved by dividing the activities between the two companies.

If the conditions for a scheme of reconstruction are satisfied, the relief at Section 136 should apply so that B is deemed not to have disposed of the shares in A Ltd or to have acquired shares in B Ltd. Instead, the shares in the B Business are treated as being the same shares, which we call the "no disposal" fiction.
The other relief is at Section 139, which states that, so long as the transfer of the business by A Ltd to B Ltd is pursuant to a scheme of reconstruction, and no consideration passes, the transfer is deemed to be at no gain no loss (i.e., cost plus indexation, in practice) so that no chargeable gains arise in A Ltd. A similar rule exists for the transfer of any intangible fixed assets, such as goodwill, found in Section 818 of the Corporation Tax Act (CTA) 2009.

The distribution in specie demerger is also a distribution for tax purposes, so it needs a specific exemption from the income tax charge that would arise on the distribution. This only applies if the relevant detailed conditions of Section 1081 et seq. of the Corporation Tax Act (CTA) 2010 are all satisfied, the most restrictive condition being that this method can only be used for dividing trading activities, not investment businesses. So this method is often not applicable, and we have to look at liquidations or reductions of capital.

**Liquidation**

A simple liquidation demerger would proceed by having a reorganization of share capital as previously described, and then placing A Ltd into liquidation. Under Section 110 of the Insolvency Act 1986, the liquidator is entitled to transfer the assets of the A Business to the benefit of A and of the B Business to the benefit of B. Each of the parties would set up a new company and the A Business would be transferred to NewCo A which would issue shares to A, and the B Business would be transferred to NewCo B which would issue shares to B. As a result, the A Business would cease to exist, but each of the relevant shareholders would own a separate company with the relevant business within it (see Diagram C).
We would expect both sides of the transaction to satisfy the conditions for being a scheme of reconstruction, so that, generally, the transaction would be free of capital gains tax or corporation tax on gains.

**Reduction Of Capital**

In a reduction of capital, the Companies Act rules are employed to allow a company to reduce its share capital.

![Diagram D – reduction of capital]

In Diagram D, it can be seen that, after the preliminary reorganization of shares into A and B shares, the B shares are cancelled. This allows the transfer of the B Business to B Ltd, which issues shares to B. This looks structurally very similar to the distribution *in specie*, and the tax reliefs apply accordingly.

**HMRC Clearances**

The conditions for the main tax reliefs for schemes of reconstruction to apply are, generally, that the transactions are carried out for *bona fide* commercial reasons and are not part of a scheme or arrangements for the avoidance of capital gains tax, corporation tax or income tax. It is normal to seek pre-transaction clearance to this effect from HMRC under Sections 138 and 139(5).

For distributions *in specie*, pre-transaction clearance is available from HMRC under Section 1091 of the CTA 2010 that the conditions for the relief from the income tax charge are satisfied.