

Demergers – Capital Reduction Demerger

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INTRODUCTION

Companies are increasingly turning to demergers as a method of separating out various parts of a business. The decision to split off a trade or subsidiary from a company or group may be undertaken for a multitude of reasons including streamlining operations, ring-fencing liabilities, succession planning or shareholder disputes.

There are three broad routes to carrying out a demerger:

1. The statutory route (an exempt demerger)
2. Liquidation under the Insolvency Act 1986
3. Reduction of capital (a Companies Act 2006 reconstruction)

This note focuses solely on the capital reduction route, covering the key tax implications and the principal qualifying requirements.

Parts 1 and 2 of this demerger series focus on demergers under the alternative routes of (1) a statutory demerger and (2) a liquidation reconstruction.

A capital reduction demerger is an alternative to a statutory demerger where the requirements of the latter cannot be met. In practice there are two main reasons why a statutory demerger is not possible, either because there are companies in the group that are not trading companies, or because the demerger is in anticipation of a sale of one or more of the companies involved in the demerger.

A capital reduction demerger is also seen as an alternative to a liquidation reconstruction where, for example, the shareholders do not wish to be associated with a company liquidation. It is often the natural choice where the company being demerged wishes to continue and has sufficient share capital to effect the capital reduction.

Capital reductions have been used more widely following the changes in Companies Act 2006, which removed the requirement to apply to the courts to enable a limited company to reduce its share capital.

BASIC STEPS

In order to outline the basic mechanics, assume a holding company with two subsidiaries, and there is one shareholder who is a UK resident individual. The shareholder wants to

separate the two subsidiaries so that each is held independently of the other. The requirements for a statutory demerger are not met and the shareholders would rather not be involved with a liquidation.

There are some preliminary issues that need to be addressed before proceeding with the mechanics of the demerger, and these can be summarised as follows:

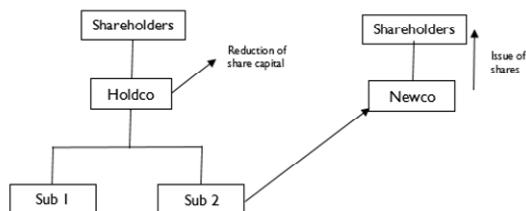
In order to effect a capital reduction demerger the company must have issued share capital of more than the value of the subsidiary being demerged from the group. If it does not, a new holding company will need to be placed above the existing holding company so that the required share capital can be created. The subsidiaries being demerged would then be hived up to the new holding company.

The directors of the holding company will need to sign a declaration of solvency as part of the capital reduction process, and there are criminal sanctions in relation to inaccurate or false declarations that they need to be fully aware of. There are other legal issues and requirements that need to be addressed in relation to a capital reduction demerger.

The basic steps to effect a capital reduction demerger would be as follows:

1. The shareholder forms a new company (Newco) with a small number of subscriber shares.
2. The holding company effects a capital reduction as follows:
 - The demerged subsidiary is transferred to Newco;
 - Newco issues new shares to the shareholder as consideration for the acquisition of the subsidiary, and in satisfaction of the capital reduction;
 - The share capital of the holding company is reduced by an amount equal to the value of the demerged subsidiary.
3. As a result of the demerger:
 - The holding company is left with a reduced share capital and continues to hold the remaining subsidiaries;
 - The shareholder will hold all the remaining share capital of the original holding company and of Newco, which holds all the issued share capital of the demerged subsidiary.

Although there are various taxes to consider in relation to these transactions, by effecting the demerger in accordance with the statutory provisions, no tax liabilities should arise in the above situation.



VARIATIONS ON THE DEMERGER STEPS

Innumerable variations on the basic demerger model are possible, so as to deal with specific situations. In every case the tax position would have to be considered to ensure that tax liabilities are mitigated as far as possible.

Where the holding company has a number of shareholders, they may want to separate subsidiaries into different ownership. This is referred to as a partition. It is still possible to avoid most of the potential tax charges apart from stamp duty, which would be payable at ½% on the value of the shares issued in each of the new companies as consideration for the companies they acquire.

There may not be a holding company, but instead the top company in the group carries on its own business. If the company has sufficient issued share capital that company can effect a demerger of one of its subsidiaries by way of a capital reduction. However, it may be necessary to put a new holding company over the existing top company by way of a share for share exchange, and then transfer some or all of its subsidiaries under the new holding company. The group would then be in a position to effect the capital reduction demerger.

Assets can be transferred between group companies in preparation for the demerger. This needs to be done with care to ensure that a corporation tax charge does not arise. Where land and buildings are transferred, there could also be an SDLT charge depending on how the transfers take place.

Whenever a capital reduction demerger is being considered it is vital that each of the steps is considered carefully to ensure that all potential tax issues are addressed. This is usually done by preparing a detailed steps plan, which also ensures that all parties understand what is involved and what documentation or agreements are required from the start.

CLEARANCE APPLICATION

A clearance application will be required to ensure that HMRC are satisfied that the demerger is being done for bona fide commercial reasons and not for the avoidance of tax. If HMRC do not give clearance and the demerger goes ahead, anti-avoidance provisions can be used by HMRC to counter what they see as a tax advantage. This could mean that on a share for share exchange a disposal of the old shares would be chargeable be capital gains tax rather than being rolled into the new shares, and in some circumstances proceeds arising from the demerger could be taxed as a dividend rather than under capital gains tax rules.

CONCLUSION

A capital reduction demerger is similar to a liquidation demerger, but is appropriate where the shareholders do not wish to disturb the wider group or are uncomfortable about being involved in a company liquidation. A capital reduction demerger is a useful alternative to a statutory demerger when the detailed requirements of the latter cannot be met. However, the steps must be considered carefully to ensure that there are no unexpected tax liabilities. It is usually possible to effect a capital reduction demerger with little or no tax liabilities arising.

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