A MATTER OF SUBSTANCE

PAUL COOPER OF KPMG LOOKS AT SOME OF THE PRACTICAL ISSUES TO CONSIDER FOR COMPANIES WISHING TO TAKE ADVANTAGE OF THE NEW 'SUBSTANTIAL SHAREHOLDINGS' CAPITAL GAINS TAX EXEMPTION.

After a long consultation, the Government has recently confirmed an exemption from capital gains tax (CGT) on the disposal of substantial shareholdings is to be introduced for disposals occurring on or after 1 April 2002. This means that qualifying share disposals made by companies will be exempt from tax where there is a gain, but equally capital losses will not arise on disposals which are standing at a loss. The Government's aim is to stop tax costs hampering deals with sound commercial rationale. However, the detailed conditions mean that this will not always be achieved.

DRAFT LEGISLATION. The revised draft of the proposed legislation contains a number of amendments to the original tabled last year. In order to qualify for the relief the following conditions must be met:

- There must be a substantial shareholding, ie a holding of 10% or more of the company's ordinary shares. In meeting this test the holdings of any subsidiaries, even if not UK resident, can be included. In the previous draft of the legislation a 20% holding was required.
- The company making the disposal must have held the substantial shareholding throughout a twelve month period (the 'qualifying period') beginning not more than two years before the day on which the disposal takes place. There are rules to deal with ownership spanning certain intra group reorganisations.
- The company making the disposal must have been a sole trading company or member of a trading group throughout the qualifying period and also immediately after the disposal.
- The company being disposed of must also have been a trading company or the holding company of a trading sub-group throughout the qualifying period and immediately after the disposal. The draft legislation previously included a requirement for the company being disposed of not to engage in certain financial and investment activities (which precluded leasing companies, IP ownership companies etc from qualifying). This has now been dropped in favour of a more general anti avoidance rule.

Where a substantial proportion of the gain arising on a disposal represents 'untaxed accrued profits' of a connected party, the relief is only available if it can be shown that obtaining this exemption was not the sole or main benefit expected to arise from the arrangements leading to the disposal.

WHAT DOES THIS MEAN IN PRACTICE? Whilst this relief is good news, it should be noted that it will only benefit trading groups making disposals of trading subsidiaries. Further, the level of trading activity required is high (at 80% of turnover, profits or assets etc – whichever is most appropriate) and this means that groups with, for example, significant property portfolios or cash balances, may have a problem. Since there is no statutory clearance mechanism it will be necessary for groups to undertake a detailed review of their operations throughout the qualifying period in order to determine if they will benefit from the relief. There are also other issues, particularly for groups with joint ventures, which can stop these groups from qualifying.

Further, the potential scope of the anti-avoidance rule is very wide as on any share sale giving rise to a gain, there must be an argument that the goodwill of the company being sold has appreciated during ownership and this increase has not been taxed and so is an 'untaxed accrued profit'. Therefore most disposals could apparently fall within the scope of the rule and the vendor will have to argue that avoiding tax on the sale is not the sole or main benefit of the disposal. The absence of a clearance mechanism adds to this uncertainty and we hope that the Revenue will offer some practical guidance on how they will operate this rule as soon as possible.

The Government is also introducing new rules on the taxation of intellectual property which will give a tax deduction for goodwill on asset but not share purchases. Therefore purchasers are likely to push for asset sales, whilst the vendor will presumably prefer a share sale to benefit from the CGT exemption. As such a new tax tension will exist in deal negotiations. The purchaser's position should be considered, as a better after tax return may be obtained by the vendor if the company sells assets and suffers some tax if this allows the purchaser to claim large tax deductions on the amortisation of its goodwill.

In conclusion it should not be assumed that all groups will benefit from this exemption on all of their share disposals. Anyone hoping to rely on the exemption should consider now whether they can meet the necessary conditions in terms of their activities and corporate structure.

Paul Cooper AMCT, a Senior Manager in KPMG's M&A Tax practice.
paul.cooper@kpmg.co.uk