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Current Note

Reform of the substantial shareholdings exemption

Although the principal considerations for the structuring of global business operations and investments usually focus on commercial and operational factors, such considerations are not looked at in a vacuum. Invariably, the financial modelling of any investment structure will also take into account the tax cost of profit extraction and exit. Accordingly, in the UK context, this requires consideration of, among other things, the UK corporation tax treatment of distributions from, and gains on the disposal of, shareholdings; the UK corporation tax exemption for such gains, known as the substantial shareholdings exemption (the SSE), is the focus of this note.

The introduction of the SSE in April 2002 marked a policy shift by the UK Government (the Government) which was largely welcomed by taxpayers; prior to this date, no equivalent exemption existed in the UK. However, since its introduction, businesses have had to contend with a number of practical drawbacks to the SSE's application and various inherent complexities. These drawbacks and complexities can, in practice, deter the structuring of operations and investments through the UK. Although, when originally enacted, the SSE may have provided an attractive exemption regime (and certainly more attractive than no exemption at all), given subsequent changes to both the domestic and international tax landscape, it is questionable whether the SSE meets its purported objectives, particularly with respect to global business and international investment.

It is against this backdrop that the Government published a consultation document on reform of the SSE in May 2016 (the ConDoc) setting out a number of options for reform and recognising the practical difficulties in applying the SSE.[1] Following this consultation, at the Autumn Statement 2016[2] it was announced that the SSE would be reformed with effect from April 2017, with draft legislation to implement such reform published on 5 December 2016 (the Draft Legislation).[3]

This note considers the extent to which the Draft Legislation addresses the practical difficulties currently faced in applying the SSE and in particular whether the Draft Legislation implements the stated aims described in the ConDoc, including the aim of increasing the competitiveness of the UK as a holding company jurisdiction.

[1] HM Treasury, *Reform of the substantial shareholdings exemption* (May 2016), available at: *https://www.gov.uk/government/consultations/reform-of-the-substantial-shareholdings-exemption* [Accessed 15 February 2017].

[2] HM Treasury, Policy paper, *Autumn Statement 2016* (23 November 2016), available at: *https://www.gov.uk/government/topical-events/autumn-statement-2016* [Accessed 15 February 2017], s.5.8 "Corporate tax - Substantial Shareholding Exemption (SSE) reform".

[3] Draft provisions for Finance Bill 2017, cll.27 and 28, available at: *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/574680/newbook_book.pdf* [Accessed 15 February 2017].

Overview of the SSE

Where certain requirements are met, the SSE has the effect of automatically exempting any gain (or disallowing any loss) arising on the disposal of shareholdings from the scope of UK corporation tax. The requirements that need to be satisfied at the time of the disposal for the main SSE to apply are:

1. *the substantial shareholding requirement*: the investor (seller) must have held a substantial shareholding in the investee (target) throughout a 12 month period beginning not more than two years before the day on which the disposal takes place (the qualifying period).[4] The investor is considered to have held a substantial shareholding in the investee if it[5]:
   (a) holds not less than 10 per cent of the investee's ordinary share capital;
   (b) is beneficially entitled to not less than 10 per cent of the profits available for distribution to the investee's equity holders[6]; and
   (c) would be beneficially entitled to not less than 10 per cent of the assets available for distribution to equity holders on the investee's winding up;
2. *the investor requirement*: the investor must: (a) have been a sole trading company or, if part of a group, a member of a trading group throughout the qualifying period; and (b) be a trading company or a member of a trading group immediately after the disposal[7]; and
3. *the investee requirement*: the investee must: (a) have been a trading company or the holding company of a trading group (or subgroup) throughout the qualifying period; and (b) be a trading company or a holding company of a trading group (or subgroup) immediately after the disposal.[8]

For the purposes of the investor and investee requirements:

- The company or group (as applicable) will be treated as trading if its activities do not include to a substantial extent activities other than trading activities (see below).[9]
- Broadly, a group includes a company (the principal company) and all the subsidiaries in which it (or a subsidiary of it) holds more than 50 per cent of the ordinary share capital (a 51 per cent subsidiary), provided that each subsidiary is an "effective 51 per cent subsidiary" of the principal company.[10]
- A subsidiary is an effective 51 per cent subsidiary of the principal company if the latter is beneficially entitled to more than 50 per cent of profits available for

[4] FA 2002 Sch.8 Pt 1 inserting TCGA Sch.7AC, para.8.
[5] FA 2002 Sch.8 Pt 1 inserting TCGA Sch.7AC, para.8.
[6] The concept of "equity holder" captures a wider group of stakeholders in a company than merely shareholders. For instance, it also includes a loan creditor of the company in relation to a loan other than a normal commercial loan.
[7] FA 2002 Sch.8 Pt 1 inserting TCGA Sch.7AC, para.18(1)(a) and (b).
[8] FA 2002 Sch.8 Pt 1 inserting TCGA Sch.7AC, para.19(1)(a) and (b).
[9] FA 2002 Sch.8 Pt 1 inserting TCGA Sch.7AC, paras 20(1) and 21(1).
[10] TCGA s.170 and Sch.7AC, para.26.

distribution to equity holders and would, on a winding up, be beneficially entitled to more than 50 per cent of the assets available for distribution to equity holders.[11]

- A subgroup includes companies that would form a group but for the fact that one of them is a 51 per cent subsidiary of another company.[12]

HMRC's view is that, for the purposes of the investor and investee requirements, a company, group or subgroup (as applicable) whose non-trading activities amount to more than 20 per cent of its total activities (excluding intra-group or intra-subgroup activities) will be carrying on to a substantial extent activities other than trading.[13] Consequently, the SSE would not apply in those circumstances. When applying the 20 per cent trading test, factors to consider include turnover, value of assets, staff time and costs, and trading history.[14]

Practical difficulties with the SSE

Practical difficulties can (and frequently do) arise when applying the SSE. In particular, the group and trading elements of the investor and investee requirements may cause difficulties, for example:

1. when deciding whether to establish a holding company in the UK, it is often difficult to know (or predict with any certainty) whether the SSE would apply in respect of a future disposal by such a holding company of its shareholdings and, in the case of certain investors, such as sovereigns and pension funds, the investor requirement may not be met in any event given the nature of the activities undertaken by those investors;
2. at the time of the disposal of any shareholding, a complex, time-consuming and often costly analysis (in some cases of the whole corporate group) will be required to determine whether the trading requirements are met even where, from a "lay person's" perspective, there may be little doubt that the company or group (as applicable) should be treated as trading (in the ordinary sense of the term);
3. activities that many businesses would consider should be eligible for exemption will not always qualify (for example, the active management of a real estate portfolio by its owner);
4. even if the investor requirement is met for the qualifying period, the requirement to be trading immediately following the disposal can cause practical issues where the disposal proceeds are not immediately reinvested following the disposal[15]; and

[11] TCGA s.170 and Sch.7AC, para.26.
[12] TCGA s.170 and Sch.7AC, para.26.
[13] HMRC, Internal Manual, *Capital Gains Manual* (2016), CG53116, "Substantial shareholdings exemption: the trading company/group/subgroup requirements - when are non-trading activities substantial".
[14] HMRC, above fn.13, CG53116–53116E.
[15] Although the "subsidiary exemption" set out in TCGA Sch.7AC, para.3 may be of use where the main exemption is not available, its availability may depend on the investor being liquidated shortly after the disposal. This may not be possible for a range of reasons (including, for example, the need to maintain the investor's existence from a warranties and indemnities perspective).

5. the requirement for the investee to be trading immediately following the disposal puts the availability of the SSE for the investor on that disposal at the mercy of factors beyond its control.

However, it is not only the investor and investee requirements that may result in practical issues. Although less common, difficulties may also arise when applying the substantial shareholding requirement:

1. where an investor holds a significant interest (in terms of amount invested) in the investee, but the 10 per cent threshold is not met (which, for instance, is often the case with infrastructure investments), the SSE would not apply on a disposal of that interest; and
2. commercial and market restrictions may require a partial "sell down" of an equity stake, resulting in a "rump" shareholding of less than 10 per cent (this may arise on initial public offerings for instance as well as joint venture or co-investment arrangements).

The domestic tax landscape

Since the introduction of the SSE there have been fundamental reforms to the UK corporate tax system. Of importance when considering the UK as a holding company jurisdiction, these reforms include: 1. the introduction of the permanent establishment exemption in 2013; 2. reform of the controlled foreign company rules in 2013; and 3. the introduction, in 2009, of an effective exemption from UK corporation tax on the receipt of most distributions by UK corporates (the Distribution Exemption). These changes marked a modernisation of UK corporate tax policy; a move from a global to a territorial tax system, with targeted safeguards against abuse built into the design of the new rules.

Against this backdrop, the SSE is perhaps an anomaly which has resulted in a certain degree of incoherence within the UK corporate tax system. Unlike other jurisdictions where there is a consistent approach to the application of corporate taxation to the extraction of profits (for instance, a close similarity in approach to dividend and gains participation exemptions) there is an apparent disconnect in the UK (illustrated by the misalignment of approach between the Distribution Exemption and the SSE) which may distort commercial decision-making. Whereas the Distribution Exemption allows business to plan effectively and provides a degree of certainty in terms of financial planning and forecasting, the same cannot be said for the SSE. What is good for the goose will not necessarily be good for the gander. This inequality of treatment significantly impacts on the attractiveness and competitiveness of the UK as a holding company jurisdiction.

The international tax landscape

In addition to considering how the SSE fits within the wider UK corporate tax framework, the comparability of the SSE to equivalent regimes in other jurisdictions (and the impact this may have on the UK's competitiveness) should be considered. What follows is a high-level summary of the writers' broad understanding of the equivalent regimes in those jurisdictions commonly regarded as the principal European holding company jurisdictions:

1. *Cyprus*: gains on the sale of shares by a Cypriot company are generally exempt.
2. *Ireland*: gains on the sale of shares in a company located in Ireland or an EU/treaty state by an Irish company are generally exempt, provided that requirements broadly equivalent to the SSE are met except that: (a) there is a 5 per cent holding threshold; and (b) there is no investor requirement.
3. *Luxembourg*: gains on the sale of shares by a Luxembourg company are generally exempt if:
   (a) the participation has been held for an uninterrupted period of at least 12 months;
   (b) the participation does not fall below 10 per cent or below an acquisition cost of €6 million throughout such period; and
   (c) the investee is subject to tax at a rate of at least 9.5 per cent based on Luxembourg tax principles.
4. *Malta*: gains on the sale of shares by a Maltese company are generally exempt if:
   (a) it holds at least 10 per cent of the investee; or
   (b) its acquisition cost was at least €1.164 million and the shares have been held for an uninterrupted period of 183 days.
5. *The Netherlands*: gains on the sale of shares by a Dutch company are generally exempt if:
   (a) it has held a participation of at least 5 per cent in the investee; and
   (b) one of the following is satisfied:
      (i) the investee is not held as a portfolio investment; or
      (ii) the investee is subject to a reasonable effective tax rate (10 per cent) based on Dutch tax principles; or
      (iii) on a fair market value basis less than 50 per cent of the investee's assets consist of "passive" assets.

From a brief examination of the approach taken by these jurisdictions, it is apparent that the SSE offers a less flexible approach particularly as regards the substantial shareholding and investor requirements.

Options for reform of the SSE

It is against this backdrop that the ConDoc was published, and it is therefore against this backdrop that the proposals set out in the ConDoc should be judged.

The stated aims of the ConDoc were to make the SSE "simpler, more coherent and more internationally competitive"[16] and listed four "drivers for change"[17]:

1. simplicity: reduce the complexity and unpredictability of the SSE;
2. competitiveness: address concerns that the SSE is detracting from the UK's attractiveness as a holding company jurisdiction;

[16] HM Treasury, ConDoc, above fn.1, para.1.8.
[17] HM Treasury, ConDoc, above fn.1, Ch.3.

3. coherence: align the SSE with the move from a worldwide to a territorial tax system and remove distortions within the UK corporate tax system; and
4. Base Erosion and Profit Shifting (BEPS): ensure the SSE achieves outcomes that are consistent with BEPS policy objectives.

In order to achieve its stated objectives, the ConDoc listed five principal options for reform[18]:

- *Option 1 (comprehensive exemption)*: subject to appropriate safeguards, wide-ranging exemption with minimal requirements as to the nature or activities of the companies involved in the transaction.
- *Option 2 (exemption subject to investee requirement[19])*: retention of the investee and substantial shareholding requirements, but removal of the investor requirement.
- *Option 3 (exemption subject to investee requirement other than trading)*: alternative investee requirement not based on the trading/investment distinction (for example, an active business test or "white list" approach).
- *Option 4 (amended trading tests at both investee and investor level)*: application of the investor and investee requirements to the seller entity and the target entity only, or retention of the existing requirements with extended definition of a qualifying activity.
- *Option 5 (changing the definition of "substantial shareholding")*: covering situations where disposals would not otherwise satisfy the substantial shareholding requirement.

It is apparent that Option 1 would go the furthest in achieving the stated aims of the ConDoc. Not only would Option 1 increase the international competitiveness and simplicity of the SSE, but also this approach would be consistent with the broader direction of UK corporate tax policy. However, whilst appropriate safeguards could be incorporated into the design of a comprehensive exemption, it was apparent from the ConDoc that this was not the Government's preferred option.[20]

The principal benefit of Options 2 and 3 was that the investor requirement would be removed. Whilst this approach would allow a broader range of investors to benefit from the SSE, the investee requirement would be retained in one form or another. Although Option 3 sought to address any concerns resulting from the retention of the investee requirement, it was not entirely clear whether any of the alternatives to trading would, in practice, effectively address the identified difficulties.

Option 4 actually comprised two options. The first option was for the investor and investee requirements to be retained but only for the parties involved in the transaction and not their wider groups. Although this would simplify the SSE, requiring the investor to be trading would be inconsistent with the aims of the ConDoc, including the promotion of the UK as a holding company jurisdiction. The second option was a variant of Option 3 with an alternative to the

[18] HM Treasury, ConDoc, above fn.1, Ch.4. In addition to these options for reform, the ConDoc included options for targeted SSE reform for the funds sector and certain technical modifications (see Chs 5 and 6).
[19] The writers have used the terms "investor requirement"/"investee requirement" throughout this note for the purposes of consistency.
[20] HM Treasury, ConDoc, above fn.1, para.4.13.

trading test applying at the investor and investee level; again it is questionable how effective such reform would be in practice.

Option 5 focused on reform of the substantial shareholding requirement to address practical issues arising on disposals of large long-term shareholdings which do not satisfy the 10 per cent test. Although not stated in the ConDoc options to address this may have included: 1. reducing the threshold to, say, 5 per cent (as in Ireland and the Netherlands); and/or 2. introducing an "acquisition cost" test (as in Luxembourg and Malta). However, the Government was "generally sceptical" of the merits of such reform.[21]

Reform of the SSE

Following the Autumn Statement of 2016, the Draft Legislation was published and takes effect for disposals of shareholdings made on or after 1 April 2017. The Draft Legislation, if enacted as drafted, would reform the SSE by[22]:

1. modifying the substantial shareholding requirement so that it applies where the investor has held the requisite 10 per cent throughout a 12 month period beginning not more than six years (rather than two years) before the day on which the disposal takes place;
2. removing the investor requirement;
3. removing the post-disposal investee requirement except where the disposal is to a person connected (within the meaning of section 1122 of the Corporation Tax Act 2010) with the investor; and
4. introducing a broader exemption for disposals by investors owned directly or indirectly by certain qualifying institutional investors (QII)[23] where the investee requirement would not otherwise be met which requires only the satisfaction of the substantial shareholding requirement which is itself extended through the introduction of a minimum £50,000,000 acquisition cost test as a possible alternative to the existing substantial shareholding requirement (the QII Exemption).

With respect to the QII Exemption, where 80 per cent or more of the ordinary share capital (OSC) of the investor is owned by QIIs immediately before the disposal, provided that the (amended) substantial shareholding requirement is met, no chargeable gain or allowable loss would arise on a disposal of an investee. However, where QIIs hold at least 25 per cent but less than 80 per cent of the OSC of the investor immediately before the disposal, the amount of any gain or loss arising on the disposal of the investee would be proportionately reduced to the extent of the QIIs' ownership percentage in the investor. For instance, if a QII holds (directly or indirectly) 50 per cent of the OSC of the investor, 50 per cent of any gain would be exempt. If the QII holds less than 25 per cent of the OSC of the investor, or holds the investor indirectly through an entity which is not itself a QII *and* is listed on a recognised stock exchange, the QII Exemption would not apply on a disposal by that investor.

[21] HM Treasury, ConDoc, above fn.1, para.4.33.
[22] Draft Legislation, above fn.3.
[23] Such as pension schemes, life assurance businesses, sovereign wealth funds, charities, investment trusts, and widely marketed UK investment schemes.

Somewhat curiously, where the investee requirement is met, the QII Exemption would not apply. While the investor would hope to avail itself of the main SSE, this may not be possible where the substantial shareholding requirement is not met.

If implemented as proposed, the Draft Legislation goes some way to addressing the practical difficulties that have arisen to date in applying the SSE and remedying the identified incoherence within the UK corporate tax system.

Whilst the QII Exemption is a positive development, it is narrow in scope (an alternative would have been to provide a general exemption for the wider funds sector). Further, the extent to which a disposal by an investor owned by a QII will be exempt will still depend upon whether the investee requirement will be met because, if it is, the investor will not fall within the scope of the QII Exemption at all. Although it is helpful that an acquisition cost test has been introduced as part of the QII Exemption, it is disappointing that this reform will not apply more widely; the policy rationale for this distinction is not clear.

Finally, the Government's response to the ConDoc notes that it will continue to monitor the SSE, including considering whether a comprehensive exemption should be introduced in the future.[24]

A more competitive regime?

The final question to consider is whether the proposed reforms increase the competitiveness of the UK as a holding company jurisdiction which was one of the stated aims of any reform.

Although a comprehensive exemption would likely have attracted more overseas interest, the proposed reforms should still enhance the competitiveness of the UK. Whilst not putting the UK on a par with Cyprus or Malta, it does improve the standing of the UK vis-à-vis Ireland, Luxembourg and the Netherlands. Although it could be argued that the Luxembourg and Dutch regimes remain more attractive (given the less restrictive shareholding thresholds and investee requirements), in a post-BEPS environment, it does not necessarily follow that these more flexible requirements make Luxembourg and the Netherlands more attractive holding company jurisdictions than the UK. For this reason, the writers consider that a comparison of the SSE with the approach taken in the other G7 jurisdictions is merited. In summary, the writers understand that broadly:

1. the US, Japan and Canada do not have an equivalent regime and would tax any gains at the applicable corporate tax rate; and
2. subject to satisfaction of certain requirements, there is only a partial participation exemption in France, Germany and Italy (88 per cent, 95 per cent and 95 per cent respectively).

Therefore, when compared with the other G7 jurisdictions, the SSE is arguably a more competitive regime on the basis that, provided the requirements are met, the UK offers a 100 per cent exemption.

[24] HM Treasury, *Reform of the substantial shareholdings exemption: response to the consultation* (2016), available at: *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/574189/final_substantial_shareholding_exemptions_condoc_response.pdf* [Accessed 15 February 2017], 4.

That being said, whilst the French and German regimes may only provide partial exemption (resulting in tax leakage on a disposal) they may provide relief (albeit only partial relief) on a broader range of disposals as, based on the writers' broad understanding:

1. in France, provided that the target is not a real estate company, relief is available where the target is booked as a "*titre de participation*" in the accounts of the seller, which is understood to be broader than "trading"[25]; and
2. in Germany, there is no minimum shareholding requirement (albeit that a 10 per cent threshold is under discussion), no required holding period and the exemption does not turn on the trading status of the seller or target.

In practice, whether one regime is more competitive than another will turn on the specific facts. However, broadening the circumstances in which the SSE may apply is clearly helpful.

Final remarks

The SSE was in need of reform; for too long it was an outlier in the UK corporate tax system. By recognising the practical difficulties in applying the SSE and incorporating feedback from industry and tax professionals, the Draft Legislation goes some way to addressing these difficulties. For this the Government should be applauded. Although the SSE may only be one factor to consider when structuring business operations and investments, the reforms should positively contribute to the enhancement of the UK as a holding company jurisdiction.

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[25] *Titres de participation* is an accounting concept but, broadly, applies where the shares in the target 1. are anticipated to be held for the medium/long term, and 2. the holding of which is considered to be in the corporate interest of the shareholder. Although the classification of a holding as a *titre de participation* generally turns on accounting principles, in certain cases the tax rules provide that a holding will be treated as a *titre de participation* (for instance, where the EU Parent-Subsidiary Directive (Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2011] OJ L345/8) would apply in respect of distributions by the target to the shareholder).

Capital gains; Consultation; Corporation tax; Holding companies; International taxation; Substantial shareholding exemption

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