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Section 27: substantial shareholding exemption; Section 28: substantial shareholding exemption: institutional investors

Where certain requirements are met, the UK substantial shareholding exemption (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 on chargeable gains.

Since the introduction of the SSE by the UK Government (the Government) in April 2002, businesses have had to contend with a number of practical drawbacks to its application and various inherent complexities. These drawbacks and complexities can, in practice, deter the structuring of operations and investments through the UK. In May 2016 the Government published a consultation document[1] setting out a number of options for reform of the SSE. Draft legislation to implement such reform was published on 5 December 2016 (the Draft Legislation),[2] such legislation being amended in March 2017.[3]

Section 27 (substantial shareholding exemption) and section 28 (substantial shareholding exemption: institutional investors) of the Finance (No.2) Act 2017 (F(No.2)A 2017) amends the existing SSE and introduces a broader exemption for disposals by certain entities.

Section 27: substantial shareholding exemption

Section 27 F(No.2)A 2017 amends the existing SSE by:

[1] HM Treasury, *Reform of the Substantial Shareholdings Exemption: consultation* (26 May 2016).
[2] Draft provisions for Finance Bill 2017 cll.27 and 28.
[3] For an overview of the SSE, the consultation process and the Draft Legislation, see O. Walker and S. Pibworth, "Reform of the Substantial Shareholdings Exemption" [2017] BTR 1.

1. removing the investing company requirement (that is, the requirement for the investing company to be a sole trading company or member of a qualifying group both pre- and post-disposal)[4];
2. modifying the substantial shareholding requirement so that it applies where the investing company 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[5];
3. extending the substantial shareholding requirement so that it takes into account the holding period for the whole group where the investing company has acquired the shares in the investee company via an intra-group transfer even if the intra-group transfer was from a non-UK group company. This was not included in the Draft Legislation and is a welcome extension to the rule[6]; and
4. removing the post-disposal investee company requirement (that is, the requirement for the investee company to be a trading company or the holding company of a trading group/subgroup immediately post-disposal) except where: (a) the disposal is to a person connected (within the meaning of section 1122 of the Corporation Tax Act 2010 (CTA 2010)) with the investing company; or (b) the investee company is a newly incorporated subsidiary to which a trade was transferred intra-group in the previous 12 months (even if that company is then sold to an unconnected party).[7]

In practice, 4(b) above is most likely to be relevant in the context of hive-downs to, and subsequent disposals of, a newly incorporated company (such a company being the investee company for these purposes). In these circumstances, the investing company may require contractual protection, specifically, that the purchaser will procure that the investee company will continue to be a qualifying company (that is, a trading company or the holding company of a trading group/subgroup) immediately after the disposal.

The amendments made by section 27 F(No.2)A 2017 have effect in relation to disposals made on or after 1 April 2017.

Whilst section 27 F(No.2)A 2017 does not go so far as to introduce a simple, comprehensive exemption similar to the equivalent regimes in Luxembourg and Malta, the amendments are welcomed and go some way to addressing the practical difficulties that have arisen to date in applying the SSE. For instance:

1. the removal of the investing company requirement will avoid the need for a complex, time-consuming and often costly analysis (in some cases of the whole corporate group) to determine whether the trading requirement is satisfied. It also

[4] F(No.2)A 2017 s.27(2).
[5] F(No.2)A 2017 s.27(3).
[6] F(No.2)A 2017 s.27(4).
[7] F(No.2)A 2017 s.27(5). The exception at (a) was included in the Draft Legislation. HM Treasury, *Finance Bill Explanatory Notes* (the Explanatory Note) (8 September 2017), "Clause 27: Substantial shareholding exemption" para.6 explains that: "The requirement is retained where the disposal is to a connected person because in those circumstances the investing company is likely to be able to influence whether the investee company continues to trade." The exception at (b) was not included in the Draft Legislation. The Explanatory Note explains at para.7, that this additional exception was included to prevent a trade from a qualifying trading company being combined with non-trading assets to make the whole disposal exempt from UK corporation tax.

avoids the practical issues that can arise where disposal proceeds are not immediately reinvested by the investing company post-disposal; and

2. the extension of the qualifying period for the substantial shareholding requirement from two to six years is helpful as, in certain situations, 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 (for instance, this can arise on initial public offerings and joint venture and co-investment arrangements).

However, challenges may well continue to arise. For instance:

1. the retention of the pre-disposal investee company requirement may well result in a complex, time-consuming and costly analysis still being required apart from in the most straightforward of cases;
2. the retention of the post-disposal investee company requirement where the disposal follows a hive-down puts the availability of the SSE for the investing company on that disposal at the mercy of factors beyond its control; and
3. where an investing company holds a significant interest (in terms of the amount invested) in the investee company, 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, instead, it would be necessary to consider whether any other reliefs are available to shelter any resulting gain.

Section 28: substantial shareholding exemption: institutional investors

Section 28 F(No.2)A 2017 introduces a broader exemption for disposals by investing companies that are not "disqualified listed companies"[8] which are owned directly or indirectly by certain qualifying institutional investors (QIIs), where the investee company requirement would not otherwise be met.[9] In such circumstances, only the satisfaction of the substantial shareholding requirement is required, and that requirement is itself extended through the introduction of a minimum £20 million acquisition cost test as a possible alternative to the existing 10 per cent substantial shareholding requirement (the QII Exemption).[10] The QII Exemption has effect in relation to disposals made on or after 1 April 2017.

Where 80 per cent or more of the ordinary share capital (OSC) of the investing company is owned by QIIs immediately before the disposal, provided that the (extended) substantial shareholding requirement is met and the investing company is not a "disqualified listed company",[11] no chargeable gain or allowable loss would arise on a disposal of an investee company.

However, where QIIs hold at least 25 per cent but less than 80 per cent of the OSC of the investing company immediately before the disposal, the amount of any gain or loss arising on

[8] F(No.2)A 2017 s.28(2) inserting TCGA Sch.7AC para.3A(2)(c).
[9] QIIs include pension schemes, life assurance businesses, sovereign wealth funds, charities, investment trusts, authorised investment funds, and exempt authorised unit trusts (see F(No.2)A 2017 s.28(5)).
[10] F(No.2)A 2017 s.28(2), (3) and (5).
[11] F(No.2)A 2017 s.28(2) inserting TCGA Sch.7AC para.3A(2)(c).

the disposal of the investee company would be proportionately reduced to the extent of the QIIs' ownership percentage in the investing company.

For instance, if a QII holds 50 per cent of the OSC of the investing company (which is not a "qualified listed company"), 50 per cent of any gain would be exempt. If the QII holds less than 25 per cent of the OSC of the investing company, or the investing company is a "disqualified listed company", the QII Exemption would not apply on a disposal by that investing company.

Although limited to investing companies owned by QIIs the QII Exemption is a positive development providing relief to such investing companies in a wider range of circumstances than would be the case under the "main" SSE (for instance, disposals of non-trading investee companies).

However, practical difficulties may still arise in applying the QII Exemption. One curious point is that the extent to which a disposal by an investing company owned by a QII will be exempt will still depend upon whether the investee company requirement is met because, if it is, the investing company will not fall within the scope of the QII Exemption at all. Therefore, it will still be necessary to undertake the analysis to determine whether the investee company requirement for the "main" SSE is met.

"Disqualified listed company"

As noted above, the QII Exemption will not be available where the investing company is a "disqualified listed company".[12] For these purposes, a company is a "disqualified listed company" if:

1. any of the shares forming part of the OSC of the company are listed on a recognised stock exchange (RSE);
2. the company is not itself a QII; and
3. the company is not a qualifying UK real estate investment trust (REIT).

In other words, if the investing company is listed on a RSE and is neither a QII nor a qualifying UK REIT it will be a "disqualified listed company" for these purposes. This represents a change in approach from that taken in the Draft Legislation. In the Draft Legislation, the QII Exemption would only have been unavailable where the QII held the investing company indirectly through an entity which was not itself a QII and was listed on a RSE (that is, the status of the investing company was irrelevant) with the result that listed investing companies could still have benefited from the QII Exemption.

Ownership

QIIs will be treated as owning the OSC of an investing company for these purposes if they own it directly, indirectly (applying sections 1155 to 1157 CTA 2010 (as amended for these purposes)), or partly directly and partly indirectly.

However, similarly to the Draft Legislation, where there is an indirect relationship between the QII and the investing company, the QII will not be treated as owning the OSC of the investing

[12] F(No.2)A 2017 s.28(2) inserting TCGA Sch.7AC para.3A(2)(c).

company for these purposes where an intermediate company through which the QII's ownership of the investing company is traced is a "disqualified listed company" (see above).[13]

The overall effect of the changes introduced by section 28 F(No.2)A 2017 is therefore that, if any of the investing company or other entities in the ownership chain between the QII and the investing company constitute a "disqualified listed company", the QII Exemption will not be available.

When applying ownership tests for UK tax purposes, issues can sometimes arise where partnerships are included in an ownership structure. Helpfully, section 28 F(No.2)A 2017 clarifies that where the assets of a partnership include the OSC of a company, each partner is to be regarded as owning a proportion of that OSC equal to its proportionate interest in that OSC (effectively, the same proportion as that partner's proportionate interest in the partnership). This clarification was not included in the Draft Legislation.

The acquisition cost test

Where at least 25 per cent of the OSC of the investing company is owned by QIIs, section 28(3) F(No.2)A 2017 introduces a minimum £20 million acquisition cost test as an alternative to the 10 per cent substantial shareholding requirement.

The acquisition cost test will be satisfied if:

1. the investing company holds ordinary shares (or interests in ordinary shares) in the investee company the cost of which was at least £20 million (helpfully reduced from £50 million in the Draft Legislation); and
2. by virtue of those shares (or interests), the investing company: (a) is beneficially entitled to not less than a proportionate percentage of the profits available for distribution to equity holders of the investee company; and (b) would be beneficially entitled on a winding up to not less than a proportionate percentage of the assets of the investee company available for distribution to equity holders.

Limb 1 of the test is fairly straightforward, looking at the consideration given for the acquisition together with any incidental costs.

Limb 2 could be more complex. In a straightforward scenario where, say, the investing company invests £30 million into the investee company and that investment means that the investing company holds 5 per cent of the OSC of the investee company and is entitled to 5 per cent of profits available for distribution and assets on a winding up, then limb 2 does not throw up any particular challenges. However, limb 2 does not just refer to shareholders but, instead, refers to equity holders (being a wider group of stakeholders in a company than just shareholders).[14] Therefore, diligence will need to be undertaken to determine the existence and respective entitlements of any such equity holders. This, therefore, adds an extra level of complexity to the analysis, and is less favourable than the equivalent tests in, say, Luxembourg and Malta.

Section 28 F(No.2)A 2017 contains a certain degree of flexibility where there is an "insignificant" difference between the percentage of OSC held by the investing company in the

[13] F(No.2)A 2017 s.28(2) inserting TCGA Sch.7AC para.3B.

[14] For instance, "equity holder" also includes a loan creditor of the company in relation to a loan other than a normal commercial loan (including loans from banks lending in the ordinary course of their business).

investee company and the investing company's percentage entitlement to profits available for distribution and assets on a winding up; this was not included in the Draft Legislation. Whilst flexibility is helpful, it is not clear what is meant by "insignificant" for these purposes and issues will undoubtedly arise for some taxpayers when applying this "insignificance" test in practice.

Finally, as noted above, it is disappointing that the acquisition cost test will not apply more widely—the policy rationale for restricting this to disposals by investing companies owned at least 25 per cent by QIIs is not clear. Leaving aside the policy rationale for excluding non-QII owned investing companies from benefiting from this extension, as these writers have previously highlighted it may have resulted in odd outcomes even for QIIs since, as originally drafted at least, the acquisition cost test would have been available for the purposes of the QII Exemption and the subsidiary exemption[15] only (that is, it would not be available for the purposes of the "main" SSE).

Such an odd outcome may be highlighted by the following example. As noted above, the QII Exemption only applies if the investee company requirement is not otherwise satisfied; if the investee company requirement is satisfied, then the "main" SSE would need to be considered. If a QII-owned investing company holds 9 per cent of the OSC of an investee (trading) company (and has done for a number of years), neither the QII Exemption nor the "main" SSE would be available because: 1. the investee company requirement would be met (thereby disapplying the QII Exemption); and 2. the substantial shareholding requirement would not be met (thereby disapplying the "main" SSE). As a result, despite its being wholly owned by a QII, the investing company would be subject to UK corporation tax on any gain arising on the disposal of some or all of its stake in the investee company, even if it satisfied the acquisition cost test.

Helpfully, albeit very late in the process, in October 2017 the UK Government recognised this shortcoming and amended section 28(3) F(No.2)A 2017 to make it clear that the acquisition cost test will apply in respect of all of the SSE exemptions (that is, not only the QII Exemption and the subsidiary exemption) where at least 25 per cent of the OSC of the investing company is owned by QIIs.[16] This is a welcome development and addresses the shortcoming outlined above.

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[15] TCGA Sch.7AC para.3.
[16] HM Treasury, *Amendments 1-2 to clause 28: Substantial shareholding exemption: institutional investors* (13 October 2017).

Capital gains; Corporation tax; Institutional investors; Substantial shareholding exemption

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