DEMERGERS
BREAKING UP IS NEVER EASY

Oliver Walker, Erica Rees and Ellie Marques of Weil, Gotshal & Manges (London) LLP outline different ways of structuring demergers and the key tax considerations in light of recent legislative changes.

In the new, post-Brexit referendum world, it appears that demergers have largely fallen out of favour, with the most recent high-profile demerger being by Esure Group plc of the Gocompare.com group in October 2016. Although there are likely numerous tax, political and economic factors behind the reduction in demergers, the introduction of section 77A of the Finance Act 1986 (1986 Act) (section 77A), which applies to share transfers executed on or after 29 June 2016 and gives rise to an additional stamp duty cost for partition demergers undertaken by way of capital reduction, will do little to reverse the trend.

This article provides a basic overview of demergers, including:

- Why a company may choose to demerge.
- How demergers can be structured.
- The key tax considerations associated with demergers.

It also considers, in particular, the impact of section 77A on partition demergers undertaken by way of capital reduction, and on liquidation demergers under section 110 of the Insolvency Act 1986 (section 110), in light of recent updates to the HM Revenue & Customs' (HMRC) Stamp Taxes on Shares Manual (the stamp taxes manual).

For the purposes of this article, references to a company refer to an English private company limited by shares.

WHAT IS A DEMERGER?

There are four main types of demerger (*see box "Types of demerger"*). Broadly, a demerger (sometimes called a "spin-off") is the segregation of a single business, which consists of different types of business activities, into distinct components. For example, Company A may conduct both retail and financial services activities but it may wish, for any number of reasons, to segregate those business activities so that they are no longer conducted by the same company (*see "Reasons to demerge" below*). A demerger would be one way of doing this.

Following the demerger, the two businesses could either be held by:

- The same ultimate shareholders; that is, the original Company A shareholders.
- Two different sets of shareholders, for example, certain shareholders may exchange their original, Company A shareholding for shares in the company that owns the segregated component of the original business. In that case, the

Types of demerger

There are four main types of demerger:

- Declaration of a dividend in specie, either direct or indirect (*Part 23, Companies Act 2006*) (2006 Act).
- Reduction of share capital (*section 641, 2006 Act*).
- Voluntary liquidation, also known as a section 110 liquidation demerger (*section 110, Insolvency Act 1986*).
- Scheme of arrangement (*Part 26, 2006 Act*).

Often a combination of the above will be used to effect a demerger. For example, a reduction of share capital is commonly combined with a scheme of arrangement or dividend in specie.

demerger results not only in a segregation of the original business but also in a change of control for both businesses, as they will each be held by different groups of shareholders following the demerger. A demerger which results in a change of control is known as a partition demerger (*see "Partition capital reduction demergers" below*).

REASONS TO DEMERGE

There are a number of different reasons why a demerger may be undertaken.

Increasing shareholder value

A demerger may increase shareholder value by allowing for realisation of the full value of each underlying business. This may be the case where the underlying businesses do not share common business goals. After the demerger, the ability of each underlying business to pursue its own objective or strategy may unlock further value for shareholders. This may also result in a better market profile for the demerged business. For example, in 2005 GUS plc demerged the luxury fashion brand Burberry, following which it demerged the credit agency Experian from Home Retail Group in 2006. As these businesses did not share a common strategy, the demerger was expected to unlock value for shareholders.

Regulatory and financial constraints

There may also be regulatory or financial reasons for a demerger. For example, the regulatory requirements applying to one particular business sector may hinder another part of the business operating in a different sector to which those requirements do not apply. Before the 2006 demerger of the Collins Stewart Tullett stockbroking business and inter-dealer broking business, the entire group had been subject to certain regulatory and capital maintenance requirements. However, following the demerger, the inter-dealer broking business was free to operate without the constraint of those requirements.

Sale to third party

Where market conditions make it more difficult to complete a sale of a business to a third party, demergers may provide a useful alternative. This is because they allow for the segregation of a particular component of the business which can then be marketed separately, potentially attracting interest from more buyers. For example, in 2008 Cadbury Schweppes demerged its Americas Beverages unit. Difficult debt market conditions made a sale unlikely, so the demerger was seen as a suitable alternative. Had this demerger not occurred, Cadbury plc may have been too large to attract a successful takeover bid by Kraft in 2010.

KEY TAX CONSIDERATIONS

Tax is one of the key considerations affecting the choice of demerger structure. Broadly, the aim of any demerger structure, from a tax perspective, is to endeavour to ensure that the arrangements are tax neutral for all parties involved. This will involve structuring the demerger so that, where possible:

- Any income or chargeable gain arising from the demerger is exempt from tax in the hands of the shareholders, or at least, in the case of chargeable gains, no income or chargeable gain is crystallised as a result of the demerger.
- The parent company is not subject to corporation tax on the disposal of the demerged business.
- No de-grouping charge arises for any company involved in the demerger.
- No VAT applies to the demerger.
- No charge to stamp duty or stamp duty land tax arises in respect of the demerger.

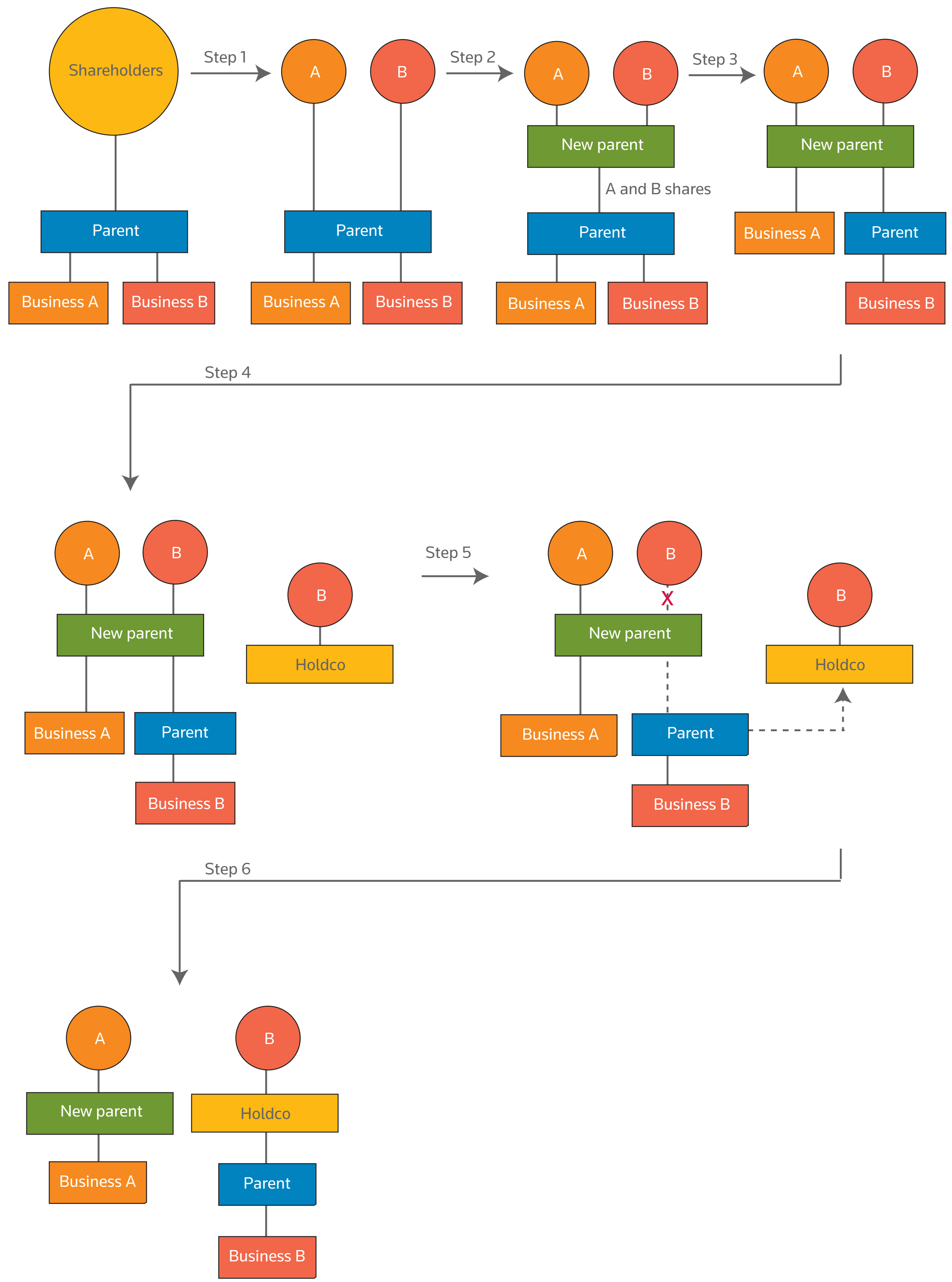
IMPACT OF SECTION 77A

Under the Finance Act 2016, the 1986 Act was amended to introduce both a new subsection (3)(i) to the existing section 77 (section 77) and a new section 77A. These changes introduce an additional condition for section 77 stamp duty relief on a share-for-share exchange.

A common feature of both a capital reduction demerger and a liquidation under section 110 of the Insolvency Act 1986 (section 110) demerger is the insertion of a new holding company above the existing parent company. For capital reduction demergers, the insertion of the new holding company is needed if the existing parent company does not have sufficient share capital to implement the subsequent reduction of capital. However, a new holding company may also be desirable for commercial (non-tax) reasons. In the case of section 110 liquidation demergers, the introduction of a new, clean holding company should help to streamline the liquidation process by reducing the time and costs associated with liquidation. It may also be desirable from a reputational perspective as suppliers, customers or debt finance providers of the existing parent company may be concerned if the company is placed into liquidation, even where it is a voluntary, solvent liquidation process.

Provided that the specific conditions of section 77 are met, relief from UK stamp duty should be available where a new holding company is introduced into a structure under a share-for-share exchange. In a demergers context, this should be the case where shareholders in the existing parent company (the parent), being the company which holds the business to be demerged, exchange their shares in the parent for shares in the new holding company (the new parent).

Partition capital reduction demerger



Requirements of section 77

Before 29 June 2016, relief from UK stamp duty would have been expected broadly to apply where the following specific conditions under section 77 were met:

- The transfer of shares formed part of an arrangement by which the new parent acquired the entire issued share capital of the parent.
- The acquisition was effected for bona fide commercial reasons and did not form part of a tax avoidance scheme.
- The consideration for the transfer of shares consisted only of the issue of shares in the new parent to the shareholders of the parent.
- After the acquisition, each original parent shareholder became a shareholder of the new parent.
- The shareholdings in the new parent mirrored those in the parent; that is, the class and number of shares held by the original parent shareholders remained the same, or as nearly as may be the same, before and after the acquisition.

Additional condition for relief

However, for transfers effected on or after 29 June 2016, an additional condition must be satisfied under section 77(3)(i) which requires that, at the time the stock transfer form, or relevant instrument of transfer, is executed, there are no disqualifying arrangements in existence. Under section 77A, an arrangement will be a disqualifying arrangement if it is reasonable to assume that the purpose, or one of the purposes, of the arrangement is to secure that a particular person, or persons together, obtain control of the acquiring company. For these purposes, "control" has the meaning set out at section 1124 of the Corporation Tax Act 2010: broadly, a person will control a company if he has the power to secure that the affairs of that company are conducted in accordance with his wishes. "Acquiring company" means the company to which shares are being transferred as set out at section 77(1). The acquiring company would be the new parent as it is acquiring the shares of the parent.

The reason why the introduction of section 77(3)(i) and section 77A is potentially problematic for capital reduction demergers becomes evident when considering the steps required to implement a partition demerger by way of capital reduction, and the ultimate effect of this type of demerger.

PARTITION CAPITAL REDUCTION DEMERGERS

A partition demerger is a demerger that results in a change of control. A single business is split into component parts so that one part of the business (Business A) (either assets or shares in a company) is ultimately held by one shareholder or group of shareholders, and the other part of the business (Business B) (assets or shares in a company) is held by a different shareholder or group of shareholders.

Step-by-step partition capital reduction demerger

In the following example, Business A and Business B represent the parts of the business to be demerged (*see box "Partition capital reduction demerger"*). A partition demerger undertaken by way of a capital reduction typically consists of the following steps:

Step 1. The parent reorganises its share capital into two classes, A shares and B shares, which carry rights in respect of Business A and Business B respectively. One group of shareholders receives A shares (the A shareholders) and another group of shareholders receives B shares (the B shareholders). This step could happen later in the process, however, section 77 requires that the share capital of the new parent after the share-for-share exchange mirrors that of the parent before the share-for-share exchange.

Step 2. The new parent is incorporated and acquires the parent from its shareholders by way of a share-for-share exchange. The A shareholders and B shareholders now hold A shares and B shares, respectively, in the new parent, which in turn holds all of the A shares and B shares in the parent.

Step 3. The parent transfers Business A to the new parent, either by way of a dividend in specie or by a transfer of the assets or shares at book value.

Step 4. The B shareholders incorporate another new holding company (Holdco), which will acquire the parent and so also Business B (as it is still held by the parent).

Step 5 and Step 6. There is a reduction of capital of the new parent, which is effected through the cancellation of B shares. The parent and Business B are transferred to Holdco, which in turn issues shares to the B shareholders pro rata to their previous shareholdings in the new parent.

As a result of the capital reduction demerger, the business as a whole, once held jointly by A shareholders and B shareholders, has now been segregated into component parts which are held by distinct groups of shareholders, as follows:

- Business A is now held directly by the new parent and indirectly by the A shareholders.
- Business B is now held directly by the parent and indirectly by Holdco and the B shareholders.

Section 77 relief

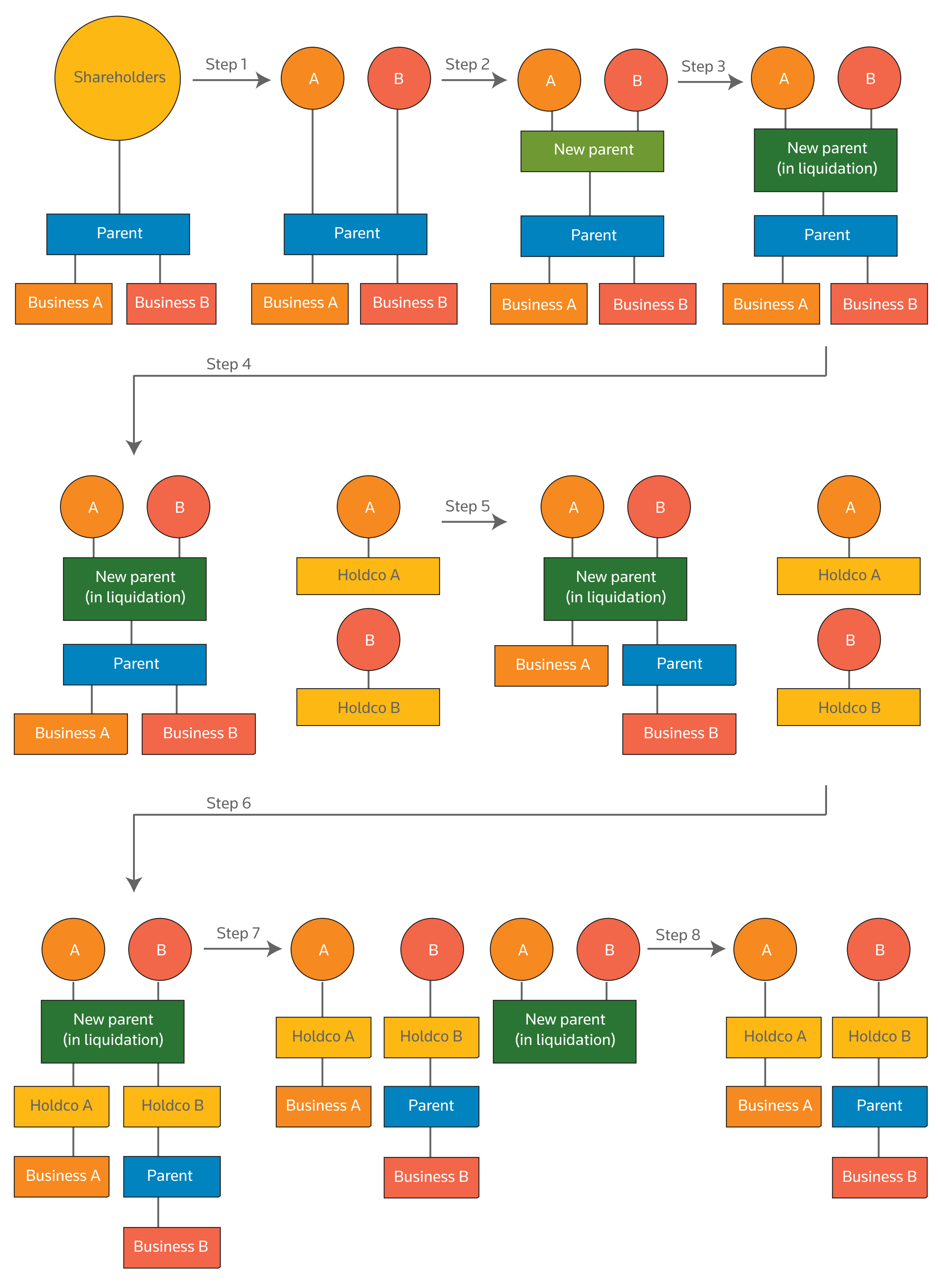
Before 29 June 2016, the introduction of the new parent by way of a share-for-share exchange at Step 2 should have benefited from section 77 relief assuming that all of the relevant conditions were satisfied.

However, the new section 77(3)(i) prohibition on disqualifying arrangements at the time of the relevant transfer (in this case, the share-for share exchange at Step 2) now precludes section 77 relief in these circumstances. As noted above, an arrangement will be a disqualifying arrangement under section 77A if it is reasonable to assume that the purpose (or one of the purposes) of the arrangement is to secure that a particular person (or persons together) obtain control of the acquiring company. At the time when the share-for-share exchange is effected in Step 2 there is, at least arguably, a disqualifying arrangement in place as, in the case of a partition capital reduction demerger, one of the purposes of the arrangement is to secure that the A shareholders ("persons together") obtain control of the new parent (the "acquiring company").

For the purposes of the change of control analysis, it is worth noting that the new parent is, at Step 2, initially controlled by the A shareholders and the B shareholders but on completion of the demerger at Step 6, the new parent is controlled by the A shareholders only.

Although there was, at least initially, some uncertainty as to whether section 77 relief would actually be denied in these circumstances, HMRC has recently confirmed

Section 110 liquidation demerger



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in an update to the stamp taxes manual that if the effect of the demerger arrangements will be that a particular person or particular persons together obtain control of the acquiring company, these will be disqualifying arrangements for the purposes of section 77A(2) as it will be reasonable to assume that the purpose or one of the purposes of the arrangements is to secure this change of control (*www.gov.uk/hmrc-internal-manuals/stamp-taxes-shares-manual/stsm042520*). The effect of HMRC's interpretation is that partition demergers undertaken by way of a capital reduction which make use of a share-for-share exchange to insert a new holding company into the structure will now likely give rise to a stamp duty cost.

It is also worth noting that, where the capital reduction demerger does not result in a partition of Business A and Business B, but instead simply segregates them under the same original shareholders, the stamp duty position for Step 2 should be different. This structural approach may be taken where, for example, there is a desire to tidy up the group structure but no need to split the ownership of the group.

In this scenario, although Business A and Business B have been separated, the same persons remain in control of each business at the end of the demerger process and, therefore, it would not be reasonable to assume that the purpose, or one of the purposes, of the demerger arrangements is to secure a change of control of the new parent. As a result, there should be no disqualifying arrangement to prevent the availability of section 77 stamp duty relief.

LIQUIDATION DEMERGERS

Section 110 liquidation demergers often make use of a share-for-share exchange to introduce a new holding company (the new parent) into the structure. In this case, the principal purpose of the introduction of the new parent is to help smooth the liquidation process. In a liquidation, creditor claims must be paid in priority to shareholder claims, but the new parent should not have any creditor liabilities and, as a result, creditor claims should not present a hurdle to the distributions to shareholders.

Step-by-step liquidation demerger

A section 110 liquidation demerger typically consists of the following steps (*see box "Section 110 liquidation demerger"*):

Step 1. The parent reorganises its share capital into two classes, A shares and B shares, which carry rights in respect of Business A and Business B respectively. One group of shareholders receives A shares (the A shareholders) and another group of shareholders receives B shares (the B shareholders). This step could happen later in the process, however, for section 77 purposes it is key that the share capital of the new parent after the share-for-share exchange mirrors that of the parent before the share-for-share exchange.

Step 2. The new parent is incorporated and acquires the parent from its current shareholders by way of a share-for-share exchange.

Step 3. The new parent is placed into voluntary liquidation and a liquidator is appointed.

Step 4. Each of the A shareholders and B shareholders incorporate a new holding company, one to hold Business A (Holdco A) and the other to hold Business B (Holdco B).

Step 5. The parent transfers Business A to the new parent, either by way of dividend in specie or by transfer of the assets or shares at book value.

Step 6. Under section 110, the liquidator transfers Business A to Holdco A in return for shares in Holdco A and Business B to Holdco B in return for shares in Holdco B.

Step 7. The liquidator distributes Holdco A to the A shareholders and Holdco B to the B shareholders. These distributions should satisfy the shareholders' rights in the new parent's liquidation.

Step 8. The new parent is dissolved.

As a result of the section 110 liquidation demerger, the business as a whole, once held jointly by A shareholders and B shareholders, has now been segregated into component parts which are held by distinct groups of shareholders, as follows:

- Business A is now held directly by Holdco A and indirectly by the A shareholders.
- Business B is now held (directly) by the parent and (indirectly) by Holdco B and the B shareholders.

Stamp duty relief

As with the partition demerger undertaken by way of capital reduction, it is the introduction of the new parent into the structure by way of a share-for-share exchange at Step 2 that requires relief from UK stamp duty under section 77. Before HMRC's revised guidance was published, there was some concern that the appointment of the liquidator would constitute a disqualifying arrangement under section 77A as it could potentially represent a change of control of the acquiring company (the new parent). This is because, once the liquidation process has been initiated, the shareholders lose their beneficial ownership (that is, their control) of the new parent, so arguably it could be said that the liquidator had obtained control of the new parent.

However, HMRC's revised guidance confirms that HMRC does not regard the appointment of a liquidator in a voluntary liquidation as a change of control for the purpose of determining whether there are disqualifying arrangements under section 77A. It states that instances where an acquiring company is wound up under arrangements other than a voluntary liquidation will be considered by HMRC on a case-by-case basis (*www.gov.uk/hmrc-internal-manuals/stamp-taxes-shares-manual/stsm042510*).

Therefore, provided that the other statutory conditions for section 77 relief are satisfied, a section 110 liquidation demerger undertaken on or after 29 June 2016 should still be able to benefit from section 77 stamp duty relief despite the introduction of the new disqualifying arrangement condition under section 77(3)(i) (*see "Requirements of section 77" above*).

AN UNPOPULAR CHANGE

So where does this leave us? Although the commercial purpose of a partition demerger may ultimately be the same regardless of whether it is undertaken by way of a capital reduction or under section 110, the stamp duty implications may be different. A capital reduction demerger may give rise to a stamp duty cost that would not arise in a section 110 liquidation demerger, even though the step in question; that is, the introduction of a new holding company by way of a share-for-share exchange, is the same in both cases.

The different stamp duty treatments prescribed for the same step in two processes, which may ultimately have the same basic goal, seems incongruous and undeserved. Practitioners in this area have commented that the changes to section 77 seem arbitrary, unfair and irrational. HMRC's revised guidance, as set out in the stamp taxes manual, has done nothing but solidify these concerns. Only time will tell how big of an impact the revisions to section 77, and the introduction of section 77A, will have on demerger structures: it is one to watch.

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