NEWS BRIEF

Reforming the substantial shareholdings exemption: keeping up with the Joneses

Following the government's announcement in the 2016 Autumn Statement that the substantial shareholdings exemption (SSE) would be reformed, draft legislation to implement the reform was published on 5 December 2016 (*see News brief "Autumn Statement 2016: key tax measures for businesses", www.practicallaw.com/4-636-1908*).

The Treasury consulted on the SSE in May 2016 with the stated purpose of making the SSE simpler, more coherent and more internationally competitive (*www.practicallaw.com/7-630-2314*) (*see box "Substantial shareholdings exemption"*). The consultation set out a number of options for reform of the SSE, ranging from the introduction of a comprehensive exemption (with minimal requirements as to the nature or activities of the companies involved in the transaction) to technical design modifications of the existing SSE.

If implemented as proposed, the reform is a positive development. By addressing the practical complexities and increasing the categories of investors that may qualify for relief, the reform should have the effect of more closely aligning the SSE with similar exemptions across Europe, thereby increasing the attractiveness and competitiveness of the UK as a holding company jurisdiction.

Substantial shareholdings exemption

Provided that prescribed conditions are met, the substantial shareholdings exemption (SSE) exempts from the charge to UK corporation tax any gain (or disallows any loss) arising on the disposal of qualifying shareholdings.

While the SSE is an important feature of the UK tax code that is often cited as a reason to invest through a UK holding structure, a number of practical difficulties may arise in its application. Principally, these difficulties often arise as a result of the dual trading requirements; for the SSE to apply both the seller (or seller group) and the target (or target group) must be trading, in each case for the requisite period (normally 12 months in the preceding two years) before, and immediately after, the disposal. These difficulties are often not present in similar regimes offered by other European jurisdictions and therefore they could be said to make the UK less competitive as a holding company jurisdiction than it might otherwise be.

The reform

If enacted in the form set out in the draft legislation, the reform would broadly comprise four elements, which would all take effect from April 2017.

Modifying the substantial shareholding requirement. Currently, the substantial shareholding requirement is only met where the seller (the investor) has held a substantial shareholding in the company whose shares are being sold (the investee) throughout a 12-month period beginning not more than two years before the disposal date (the qualifying period). Difficulties may arise where commercial or market restrictions require a delayed sell down or multiple tranche disposals where the resulting shareholding is less than 10%.

The government proposes that the qualifying period be extended to cover any 12-month period beginning not more than six years (rather than two years) before the disposal date. This should provide investors with a better opportunity to comply with any commercial or market restrictions while also being able to avail of the SSE on a future disposal of the remaining shareholding.

Removing the investor requirement. For the exemption to apply, the investor (or investor group) is required to be trading both before, and immediately after, the disposal. This is a significant drawback to the SSE, often requiring a complex and time-consuming analysis not only at the time of the disposal but also as part of the thinking done in connection with the acquisition structuring. The uncertainty inherent in having to forecast the trading profile of the investor years in advance is unhelpful in terms of the UK's competitiveness, particularly when the SSE is compared with similar exemptions in other European jurisdictions such as Ireland, Luxembourg and the Netherlands, which do not carry an equivalent requirement.

Although the second subsidiary exemption in paragraph 3 of Schedule 7AC to the Taxation of Chargeable Gains Act 1992 may assist, groups that do not wish, or are unable, to liquidate the investor shortly after the disposal will struggle to avail themselves of it. Further complications arise where there is a tower of companies between the investor and the ultimate destination of the disposal proceeds.

The government proposes to remove the investor requirement. This is a welcome development that not only brings the UK more in line with the approach taken in other European jurisdictions, but also increases certainty and effectively broadens the categories of investor that can benefit from the SSE.

Removing the post-disposal investee requirement. The investee (or investee group) is also required to be trading both before, and immediately after, the disposal. Leaving aside the difficulties that may arise in assessing whether this condition is met for the pre-disposal period, the requirement for the investee (or investee group) to be trading immediately following the disposal not only gives rise to the sort of uncertainty described above in relation to the investor requirement, but also puts the availability of the SSE at the mercy of the buyer of the investee.

While this risk may be mitigated through contractual protections such as a tax deed, this is far from perfect, and some buyers, particularly those based outside the UK that are unfamiliar with the SSE, may baulk at the idea of promising to carry on trading activities after completion (*for background, see Focus "A new creed for the tax deed: the impact of market trends", www.practicallaw.com/6-632-9465*).

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The government proposes to remove the post-disposal investee requirement where the disposal is to a person that is not connected to the investor, as defined in section 1122 of the Corporation Tax Act 2010. This would have the effect of removing the contingent nature of the SSE and again increase the certainty of its applicability.

Introducing a comprehensive exemption. The government proposes that, where the investee requirement under the main SSE is not met on a disposal, a broader exemption would be available for disposals by investors owned directly or indirectly by certain qualifying institutional investors comprising pension schemes, life assurance businesses, sovereigns, charities, investment trusts, and widely marketed UK investment schemes (QIIs), which would require only the satisfaction of the substantial shareholding requirement (the QII exemption). For the purposes of the QII exemption only, the government also proposes that the substantial shareholding requirement be extended so that it is met where either the existing 10% threshold test is satisfied or the acquisition cost of the shares being disposed of is at least £50 million.

With respect to the QII exemption, provided that the (amended) substantial shareholding requirement is met, where immediately before the disposal:

- 80% or more of the ordinary share capital of the investor (the investor OSC) is owned by QIIs, no chargeable gain or allowable loss would arise on a disposal of an investee.
- Less than 80% but at least 25% of the investor OSC is owned by QIIs, the amount of any gain or loss arising on the disposal of the investee would be proportionately reduced to reflect the QIIs' ownership percentage. For instance, if a QII holds 60% of the investor OSC, 60% of any gain would be exempt.

However, if QIIs hold less than 25% of the investor OSC immediately before the disposal, or hold the investor indirectly through a listed non-QII entity, the QII exemption would not apply on a disposal by that investor. It is also worth noting that the QII exemption would not apply where the investee requirement is met.

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The draft legislation is at clauses 27 and 28 of the draft provisions for Finance Bill 2017 at www.gov.uk/government/uploads/system/uploads/attachment_data/file/574680/newbook_book.pdf.

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