

THE SUBSTANTIAL SHAREHOLDINGS EXEMPTION REGIME AND SHARE REORGANISATIONS

Introduction

1. We have been asked to explain how the substantial shareholdings provisions apply in relation to share reorganisations, particularly within groups of companies.
2. The substantial shareholdings provisions are at Clause 43 of, and Schedule 8 to, Finance Bill 2002. Schedule 8 introduces Schedule 7AC into the Taxation of Chargeable Gains Act 1992 (TCGA). Schedule 7AC contains the substantial shareholdings exemptions.
3. We first illustrate below how the legislation operates in two different types of intra-group transaction. We then illustrate how the legislation applies to a share exchange outside a group.
4. For the purposes of the intra-group illustrations we have assumed there is a group consisting of three companies –
 - the principal company, A, and
 - subsidiaries B and C, both of which are 100% owned directly by A.
5. The group and these shareholdings are assumed to have been in place for 12 months or more and all of the companies are assumed to have been “trading companies” (for the purposes of Schedule 7AC) throughout their existence.
6. The first example involves an intra-group share exchange and the second involves an exchange of shares for qualifying corporate bonds (QCBs).
7. In what follows, references to sections and Schedules are to provisions in the TCGA.

Example 1 – An intra-group share exchange

8. In this example, company A transfers the shares in company B to company C in exchange for an issue of shares by company C to company A.
9. We shall assume for the purposes of this example that Section 137 would not prevent Section 135 from applying to the exchange.
10. Paragraph 4(1)(b) of Schedule 7AC applies for the purposes of determining whether a substantial shareholdings exemption (SSE) applies. It tells us to disregard Section 127 for these purposes.
11. Paragraph 4(5) of Schedule 7AC provides for this reference to Section 127 to include reference to that provision as applied by Section 135. So, in order to determine whether or not an SSE applies in relation to the share exchange, we disregard the effect of Section 127 as applied by Section 135 and there is a disposal by company A of the shares in company B. Let’s call this disposal “the assumed disposal”.
12. The assumed disposal is an intra-group disposal to which Section 171(1) applies, because on the basis of the assumption that there is a disposal, Section 171(3) will not have effect to switch off Section 171(1). The assumed disposal is,

- therefore, a no gain/no loss disposal. As paragraph 6(1)(a) of Schedule 7AC provides that none of the exemptions conferred by the Schedule applies to such disposals, it follows that no SSE applies in relation to the assumed disposal.
13. It is only where an SSE applies in relation to the assumed disposal that paragraph 4(3) of Schedule 7AC has effect to disapply Section 127. It follows that Section 127 (as applied by virtue of Section 135) does, in fact, apply in relation to the share exchange.
 14. This has the following consequences –
 - company A is treated as having acquired the newly-issued shares in company C at the same date as it acquired the shares in company B and at the same cost (this is the result of the “stand in shoes” rule in Section 127 as applied by virtue of Section 135); and
 - company C is treated as acquiring the shares in company B at their market value at the time of the share exchange. (This is because Section 171(1) is prevented by Section 171(3) from applying to the transfer from company A to company C of the shares in company B. The market value rule in Section 17(1) applies instead to determine company C’s acquisition cost of those shares. For more detail on intra-group share exchanges, see paragraphs 45550-45572 of the Inland Revenue’s Capital Gains manual, which is available on the Inland Revenue website at www.inlandrevenue.gov.uk.)
 15. As Section 127 applies to the share exchange, paragraphs 14 and 25 of Schedule 7AC will be relevant when determining whether the conditions are satisfied for an exemption to apply on a subsequent disposal by company A of the newly issued shares in company C. In effect, paragraphs 14 and 25 permit company A to look back through the share exchange and to take account of the time it held the shares in company B for periods before the share exchange. Paragraph 14 relates to the substantial shareholding requirement in paragraph 7 of Schedule 7AC. Paragraph 25 relates to the paragraph 19 requirements for the company invested in.
 - 15A. Turning to company C, as a consequence of paragraph 10(2)(b) of Schedule 7AC, company C is treated for the purposes of paragraph 10(1) as having acquired the shares in company B from company A by way of a “no-gain/no-loss transfer” (as defined in paragraph 10(2)(a)). This means that, in order to establish the period for which company C is treated as having held the company B shares for the purposes of Part 2 of Schedule 7AC, one looks back through the share exchange. This enables company C to benefit from the period for which company A held the shares in company B.

Example 2 – An intra-group exchange of shares for QCBs

16. In this example, company A transfers the shares in company B to company C in exchange for an issue by company C to company A of loan stock which constitutes a QCB.
17. We shall assume for the purposes of this example that, but for Section 116(5), Section 127 would apply to the exchange (by virtue of Section 135).
18. Paragraph 4(1)(a) of Schedule 7AC applies for the purposes of determining whether an SSE applies in relation to the exchange. So, in order to determine whether or not an SSE applies in relation to the exchange, we disregard the effect of Section 116(10) and there is a disposal by company A of the shares in company B. As in the first example, we shall call this disposal “the assumed disposal”.
19. The assumed disposal is an intra-group disposal to which Section 171(1) applies. Paragraph 6(1)(a) of Schedule 7AC makes it clear that the exemptions conferred by Schedule 7AC do not apply in relation to no gain/no loss disposals. Since none of the exemptions apply to the assumed disposal, paragraph 4(3) of Schedule 7AC does not have effect to provide that Section 116(1) does not apply in relation to the exchange. It follows that Section 116(10) does, in fact, apply in relation to the exchange.
20. This means that Section 116(10)(a) will require the calculation of the chargeable gain or allowable loss which would have accrued if the “old asset” (here, the shares in company B) had been disposed of at its market value immediately prior to the exchange.
21. The consequences are that company C will be deemed to have acquired the shares in company B at their market value immediately before the exchange, and
 - if the conditions for an SSE are satisfied in relation to the hypothetical disposal mentioned in Section 116(10)(a), Section 116(10)(b) will not have effect to postpone any chargeable gain or allowable loss until such time as the QCB is disposed of. This is because no chargeable gain or allowable loss accrues on the hypothetical disposal of the shares if the conditions for an SSE are met;
 - if the conditions for an SSE are not satisfied in relation to the hypothetical disposal mentioned in Section 116(10)(a), Section 116(10)(b) will have effect to postpone any chargeable gain or allowable loss accruing on that disposal until such time as the QCB is disposed of (subject to Section 116(11)). In such circumstances, paragraph 34 of Schedule 7AC prevents any of the exemptions conferred by Schedule 7AC from applying to the postponed chargeable gains or allowable losses.

Example 3 – A share exchange outside a group of companies

22. For the purposes of this example, we shall assume that company D has owned 30% of the shares in company E for 12 months or more. Company F, which has no connection with company D, acquires company D’s holdings of shares in company E in exchange for an issue of shares by company F. We shall also assume that Section 137 would not prevent Section 135 from applying to the

- exchange and that all three companies have been “trading companies” (for the purposes of Schedule 7AC) throughout their existence.
23. Paragraph 4(1)(b) of Schedule 7AC applies in relation to the exchange as described in paragraph 10 above. The effect of disregarding Section 127 here is that there is an arm’s length disposal by company D of the shares in company E to company F. This disposal produces a gain to which an SSE applies. Paragraph 4(3) therefore applies to prevent Section 127 from applying (by virtue of Section 135) to the share exchange).
24. The consequences of this are that –
- company D makes a disposal of this holding of shares in company E for consideration equal to the value of the shares issued by company F – any gain or loss arising on the disposal is, by virtue of the SSE, not a chargeable gain or allowable loss;
 - company F acquires the shares in company E at the value of the shares it issued to company D;
 - company D acquires the newly issued shares in company F at the amount or value of the consideration (the shares in E) given for them.

Contact

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