

Capital reduction demergers

(Lecture B1054 – 15.02 minutes)

In a typical scenario, a company may be operating two divisions run by separate shareholder/ directors. For some reason they have decided that they want each of those divisions to be held by a separate company, perhaps due to the individuals falling out over how to take the businesses forward. By undertaking a capital reduction demerger, the owners avoid a liquidation.

Example

Elton and Kiki own Heart Ltd equally. The company operates two divisions – one covering the London and the South East and the other the rest of the UK.

Elton and Kiki have decided that they want to separate the businesses so that each takes ownership of the division that they currently run. When looking to use a capital reduction demerger, it is quite common to insert an intermediate holding company taking advantage of the share for share exchange rules in s135 TCGA 1992. Clearance should be sought from HMRC that the transaction is for bona fide commercial reasons. While capital gains are thus not an issue, stamp duty will be payable due to the change in control that will be triggered. S77 FA 1986 relief is not available.

Once the intermediate holding company had been created, one of the divisions, say the London and South East division, is hived up into this company by distributing the goodwill and net assets of that division in specie, thus reducing the value of Heart Ltd by the carrying value of those assets. Heart Ltd is left holding the goodwill and net assets of the second division, covering the rest of the UK.

At this point the share holdings of the intermediate holding company are recategorised. Typically, Elton's ordinary shares become A ordinary shares, with it stated in the Articles that these shares entitle him to profits, assets and votes relating to the London and SE division. Similarly, Kiki's ordinary shares become B ordinary shares, with the Articles stating that these was entitle her to the profits, asset and votes relating to the Rest of the UK division. Provided that the valuations of the respective divisions correspond to their 50% holdings, this represents a simple capital gains tax reorganisation at the shareholder level, with no value shifting involved.

When Elton and Kiki subscribed for their shares in the intermediate holding company , each of them gave up half of their shareholding in Heart Ltd, making the subscription value or 'price paid' for their shares in the intermediate holding company is half of the market value of Heart Ltd.

The next step is for the directors of the intermediate holding company to make a declaration of solvency and then pass a resolution to reduce the capital by a repayment of the shares in Heart Ltd to Kiki. To ensure that corporate reorganisation relief in s139 TCGA 1992 is available and no gains arises, the 'Rest of the UK' division is transferred within Heart Ltd to a new company, Kiki Ltd, and shares in the new company, Kiki Ltd, are issued to Kiki in exchange for her old B ordinary shares in the intermediate holding company. The B ordinary shares that Kiki no longer owns have no economic value and so would be cancelled.

Following the demerger:

- Elton owns A shares in what was the intermediate holding company but now just holds the London and SE division;
- Kiki owns shares in Kiki Ltd which in turn owns Heart Ltd which owns the Rest of the UK division.

Created from a lecture by Peter Rayney