

Magical mystery tour

Should one limited company carry on more than one business?

PETER RAYNEY navigates the long and winding road of a corporate demerger case study.

Paul Macca is the 100% shareholder of Macca Hotels & Spas Ltd (MHS) and is its chief executive. On a bright summer's day in 2012, he was waiting in the boardroom for Brian Eppie, an independent tax adviser. Paul had contacted Brian a few days ago, because he wanted to obtain some advice on a possible restructuring of MHS since he felt that this was 'beyond the ken' of his current accountants.

The boardroom door swung open. Brian was soon ushered in by Paul's personal assistant and the usual introductory pleasantries were exchanged.

Paul explained some things that had been troubling him: 'My company has now developed to the stage where we have two quite separate and distinct businesses. We started our first business in 1978 – when the company acquired a hotel and spa complex in Abbey Road and in 2000 we added another one just outside Liverpool. We then diversified in 2006 by purchasing a number of 'up-market' residential care homes for about £10 million. The problem is that all this happened quite accidentally. I do not like both businesses being in the one company'.

Paul continued: 'First, it makes it difficult to brand each business separately, especially through our website, and it has created some confusion for our potential customers. We have also had a few "scary" claims in the care homes business, which thankfully were resolved at little cost, but it does make me more nervous about the future potential risk to our hotel and spa business. And another issue ... I want to give some shares to the dedicated management team that run our care homes without, of course, giving them any interest in the hotel and spa side of the business. The VAT is also a nightmare as the care homes business is exempt...'



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Restructuring options

'I fully understand all that', Brian nodded, as he had seen similar issues with some of his previous tax consultancy demerger projects. 'You have a number of possible options. We could create a separate subsidiary, say, for the care homes business. This would be wholly owned by the existing MHS. By transferring the care homes business into a subsidiary, this would "ring fence" the business. However, giving employees shares in subsidiaries is not terribly attractive from a tax viewpoint. For example, the company cannot claim any statutory tax deduction for the value of the shares and there would be PAYE and National Insurance contributions issues.'

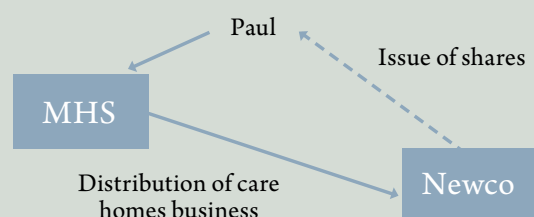
Paul interrupted, 'I was thinking more on the lines of putting the care homes business into an entirely separate company owned by me. I have already had discussions with the local authorities and they are prepared to transfer our operating licences into a new company. But I was concerned about the tax because the care homes business would now command a sale price of some £13 to £15 million. I do not want to get a massive tax bill ... that's why you are here. Can it be done?'

A smile slowly shone over Brian's face. 'Of course it can, but we have to go through a number of steps and we have to ensure that the transaction is structured in a particular way. Obviously, this is a very technical area, but let me take you through the key areas slowly. May I use your flipchart?'

KEY POINTS

- The potential problems of differing businesses operated by one company.
- Subsidiary company or separate company?
- Structuring a statutory demerger transaction.
- Conditions for relief under TCGA 1992, s 139.
- Accounting for the demerger distribution.
- Does the company have sufficient distributable reserves?

STATUTORY DEMERGER



Statutory demerger

Brian drew an outline diagram of his proposed statutory demerger of the care homes business on the boardroom flipchart – see **Statutory Demerger**.

Brian explained the various key steps as he drew. ‘There are three basic methods of structuring a statutory demerger transaction. However, based on the fact that you have a single company – MHS – and my understanding of your requirements, I suggest we transfer the care homes business to a new company – let’s call it Newco – and the consideration for the transfer of the business will be the issue of ordinary shares to you by Newco. Often, reorganisations like this are implemented by liquidating the company, but I do not see any need to do that here since both companies are trades and you do not have any current plans to sell either business, do you? HMRC will give us confirmation that we meet all the conditions under the advance clearance procedure.’ (Paul nodded).

‘Under the statutory demerger rules, we effectively declare a “dividend” or distribution of the care homes business and assets to Newco. Normally, this would be a taxable distribution and subject to income tax at distribution rates in your hands. But provided we satisfy the relevant conditions for a statutory demerger – which I think should be OK here – the distribution would be exempt in your hands.’

‘Wouldn’t there be a capital gain on the transfer of the care homes properties?’ queried Paul.

‘Good question ... well we also have to use some other reliefs to protect the capital gains positions. You are correct that a transfer of assets to a connected company could trigger a capital gain based on the market value of the assets, but here we can use the corporate capital gains tax reconstruction relief to avoid any capital gains. Broadly, this is the TCGA 1992, s 139 relief. We would have to meet a number of important conditions, which I expect to be satisfied here. Let’s summarise them:

- There must be a “reconstruction” for tax purposes – in your case this is simple since there is no change in the economic ownership of the care homes business. It will still be 100% owned by you through your 100% shareholding in Newco and Newco will issue ordinary shares to you in consideration of the transfer of the assets and trade by MHS – see my **Statutory Demerger** diagram.
- The whole or part of one company’s *business* must be transferred to another company – not a problem here since we are transferring MHS’s care homes business to Newco.
- The transfer must be for genuine commercial reasons and not for tax avoidance. Based on what you told me at the beginning, we have a number of compelling business reasons for our demerger; however, we will apply to HMRC for an advance statutory clearance to confirm “they” agree with us before we proceed.
- MHS and Newco must be UK tax resident – again no problem.
- MHS cannot receive any consideration for the transfer other than the assumption of its liabilities by Newco. Clearly, there is no consideration being given to MHS as it is making a legal distribution of the care home assets, but any assumption of liabilities by NewCo is permissible.

‘As you can see, Paul, we should be able to comfortably satisfy these requirements. This means that the care home properties can go across on a tax-neutral basis. Strictly, this means that the properties are transferred on a ‘nil gain/nil loss’ basis so Newco will effectively inherit MHS’s original base cost (plus accrued indexation). One further thing has just occurred to me. You said that the care homes properties were acquired in 2006. If there is any “free-standing” goodwill in those business – in other words, goodwill that is not reflected as part of the property value – then this would be within the scope of the corporate intangibles rules and we would obtain our required “tax-neutral” treatment under a different provision – CTA 2009, s 818. We will need to check this out just in case we need to apply for a separate reconstruction clearance under CTA 2009, s 831(2) and s 832 as well.’

Stamp duty

‘Wow. That’s cool’, replied Paul, ‘are there any stamp duty implications?’

“ A transfer of assets to a connected company could trigger a capital gain based on the market value of the assets. ”

‘You mean stamp duty land tax or SDLT. Well, we do have to tread carefully here as there are various restrictions surrounding the various SDLT reliefs. However, in this case, we should be able to benefit from SDLT reconstruction relief. This means that there should be no SDLT on the transfer of the properties. Our statutory demerger should qualify as a reconstruction for SDLT purposes provided that the share capital of Newco exactly ‘mirrors’ that of MHS *and* so long as Newco only issues (non-redeemable) shares to you or acquires relevant MHS debt. I do not expect us to have any problems there.’

Paul’s tax position

Brian then went on to explain Paul’s tax position.

‘As far as you are concerned, there should not be any immediate tax charges on the receipt of your “consideration” shares in Newco. As I’ve already mentioned, the demerger distribution is exempt so there is no income tax. Capital gains tax could potentially apply but, again, provided HMRC are satisfied that we are only doing this for genuine commercial reasons, we should be able to obtain a TCGA 1992, s 138 tax clearance to enable us to benefit from the shareholder reconstruction reliefs in TCGA 1992, s 136. In simple terms, this provides that you do not make any acquisition of your Newco shares for capital gains tax purposes. Instead, part of the base cost of your MHS shareholding will be apportioned to your Newco shares (based on the respective market values of the two companies post-demerger) and these shares will be deemed to have been acquired at the same time as your original MHS shares.’

Accounting implications

Brian then also explained how the demerger distribution would be reflected in MHS's accounts.

“There are a whole host of other areas that we will need to deal with.”

‘The main issue is to ensure that we have sufficient distributable reserves in MHS to “frank” the demerger distribution. The Companies Act 2006 makes it clear that we only need sufficient distributable reserves to declare a dividend equal to the carrying cost of the care home assets (as opposed to their current market value). However, I see that the three care homes have been revalued in the balance sheet. There is also a special rule we can use here that enables us to use the part of the revaluation surplus (in the balance sheet) attributable to the care home properties. Thus, as long as the retained reserves and the relevant part of the revaluation surplus can absorb a distribution equal to the carrying value of the care home properties and other related assets (less any assumed liabilities), we can make a legally competent distribution. Let's have a look at the numbers on the papers you sent me. The December 2011 accounts show profit and loss account reserves of around £17 million and the revaluation surplus relating to the three care home properties is £2 million. The care homes are carried in the books at £12 million and let's say that the other care home “net” assets are around

£1 million, which makes £13 million in total. In terms of “franking”, we would use the £2 million from the revaluation surplus and the balance of £11 million from accumulated profits. This would leave some £6 million in reserves plus 2012 profits to date. So, all this can be managed quite comfortably. It's very important to ensure that the company can make a legal distribution under the Companies Act 2006 otherwise the demerger would not be effective.

Paul instinctively understood that Brian knew his ‘stuff’, but his attention span was waning. ‘It's a long and winding road, isn't it Brian?’

‘Yes, there's quite a lot involved here, but it will be worth the effort. And then, of course, there are a whole host of other areas that we will need to deal with such as the transfer of the care home licences, TUPE for the employees, and other administrative issues, and so on.’

‘I think lunch beckons’, interrupted Paul. ‘You've certainly put my mind at rest that we can do this provided HMRC are satisfied about our commercial objectives. Brian, can you put together a short briefing note for me to examine more closely. Then I would like you to submit the relevant clearances to HMRC and, of course, we will need to discuss fees. I suggest you liaise with our in-house accountant, Ringo Drums, to get all the information you need. Thanks for coming over Brian ... I knew you were the man for the job!’ ■

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