Practice guide

International aspects of demergers

Speed read

Demergers are one of the most complex types of corporate transaction, especially when they involve international aspects such as non-resident companies, companies registered overseas, companies with overseas assets or trades, or non-resident shareholders. For non-resident shareholders, the main aspects requiring consideration are their potential liability to UK tax, and their exposure to local tax in their jurisdiction of tax residence. For companies registered overseas, the main issue is that their corporate governance falls under foreign corporate law provisions, so a demerger will not be carried out under UK legal principles for which UK tax law is written. For non-resident companies carrying out a demerger, care is required to look not just at the company's UK and foreign tax position, but also the consequential impact on UK shareholders.

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Demergers are complex corporate transactions that aim to split two or more businesses into separate ownership. Under UK tax and company law, it may be possible to achieve a tax-neutral demerger through the use of a statutory demerger (direct or indirect), a s 110 liquidation demerger, or a capital reduction demerger. Other simpler methods may also be possible, where mathematically the taxes arising are minimal.

Demergers – arguably one of the most complex types of corporate transaction – become even more complicated when international elements are involved. International aspects do carry additional risk, but they can also create opportunities. The important point is that the implications of undertaking a demerger with international aspects must be fully and specifically considered.

Common international aspects that we will consider in this article include:

- non-resident shareholders;
- companies registered overseas;
- non-resident companies;
- UK companies with overseas assets and trade;
- mixed groups with mixed shareholders; and
- cross-jurisdictional demergers.

Demergers: overview

In order to provide context, here is a quick overview of the taxation of demergers, including an explanation of terminology.

Statutory direct demerger: the simplest form of demerger – essentially, a distribution in specie to the shareholder, which, providing conditions have been met, is exempt from income tax under CTA 2010 s 1076. CGT relief for the shareholder is obtained through the operation of TCGA 1992 s 192 (tax exempt distributions), whereas the company must rely on the substantial shareholdings exemption to be tax-neutral, hence it tends to only be used by groups to demerge a trading subsidiary.

Scheme of reconstruction: the basis of all indirect demergers – essentially, applying where a company transfers assets to another company in consideration of the second company issuing shares directly to the shareholders in the first. It is perhaps easiest to consider those steps as two sides of a triangle, with what happens with the third side determining the tax position of the shareholders. In isolation, carrying out a scheme of reconstruction would legally constitute a distribution to the shareholders, as value has passed to them (or rather a company they own) from the first company, and this will be subject to income tax.

International aspects do complicate matters and need very careful consideration, but with appropriate international assistance, solutions can usually be found

Statutory indirect demerger: providing conditions have been met, the distribution arising from the scheme of reconstruction is exempt from income tax under CTA 2010 s 1077. CGT relief for the shareholder is then available through TCGA 1992 s 136, and for the distributing company under TCGA 1992 s 139. Similar reliefs are available under CTA 2009 Part 8 for post-2002 corporate intangibles and, subject to additional 'mirror shareholding' requirements, for stamp taxes.

Section 110 liquidation demerger: where a scheme of reconstruction is carried out during the liquidation of the company, the resulting liquidation distribution is treated as a capital gains transaction. The same reliefs noted for statutory indirect demergers equally apply here.

Capital reduction demerger (CRD): where the scheme of reconstruction is carried out in consideration of a repayment of capital, it is specifically excluded from the definition of an income distribution within CTA 2009 s 1000, and it is treated as a capital gains transaction. Again, the same reliefs noted for statutory indirect demergers apply here.

The wider transaction: usually, it is necessary to carry out a reconstruction of the distributing company/group in order to place the assets where they need to be, ready for the demerger and, in the case of CRDs, to create additional capital to be subsequently cancelled. For these steps to be tax-neutral, it is usually necessary to rely on the various 'group relief' provisions (including exceptions from de-grouping charges on the subsequent event of the demerger), corporation tax dividend exemptions, and possibly – for the shareholder – TCGA 1992 s135 (share for share exchange). This is often where the complexity lies.

Non-resident shareholders

There are two aspects that need to be considered for non-resident shareholders:

- their potential liability to UK tax; and
- their exposure to local tax in their jurisdiction of tax residence.

Of the two, the latter is usually the most critical. Foreign tax may also be an issue for individuals who are subject to tax in their home nation by reason of citizenship rather than residence; for example, US citizens and green card holders (referred to in this article as 'dual taxed shareholders').

UK tax

Although non-residents technically remain subject to income tax on UK-sourced distributions (subject to treaty relief), the operation of ITA 2007 s 811 (limit on liability to income tax of non-UK residents) means that, in practice, for the cost of foregoing their personal allowance, the income tax arising on the distribution is capped to the amount withheld at source, which under current rules is nil. Hence, we would usually be less concerned if the form of the demerger legally constituted a distribution under UK company and tax law. We note that ITA 2007 s 815 applies a similar limitation for non-resident companies within the scope of income tax.

To provide a UK tax analysis of the demerger, it is necessary firstly to understand the operation of the foreign company law, and then apply UK tax principals thereto. The problem is that UK tax law is written specifically with UK corporate law in mind ...

Furthermore, the fact that non-residents are usually outside the scope of UK CGT means that reliance on CGT reliefs is also less important. However, if a shareholder ever anticipates establishing UK tax residence in the future, whilst still holding the demerged shares, the application of the reliefs should be considered, as they may affect the ongoing base cost of the new holdings for the shareholder.

Of course, temporary non-residence rules could override both the above, and an income tax or CGT charge could arise on the date of return. So, if a non-resident shareholder has not yet been absent from the UK for at least five years, their intentions for returning should be discussed, and they should be advised of the consequences should they return early.

Foreign taxes

It is important that non-resident shareholders and dual taxed shareholders obtain local advice about the foreign taxes that could accrue to them as a result of the demerger; sometimes there can be surprising results.

See example 1.

Real life example 1: non-resident shareholders

A UK group was owned 90% by a non-resident individual. The proposal was to carry out a capital reduction demerger (CRD) to extract its substantial office premises prior to a share sale of the trading group.

Local advice was that the normal use of a share-for-share exchange to impose a new holding company and create the capital as step 1 of a CRD would be a taxable event for the non-resident shareholder. However, the tripartite demerger itself (i.e. the cancellation of shares and associated scheme of reconstruction) was confirmed to be tax-neutral locally.

Solution:

1. The non-resident shareholder bought out the two minority UK shareholders for full value.
2. Capital was created out of reserves through a bonus issue of shares to the now sole shareholder.
3. The CRD then proceeded in the normal way, cancelling the share capital created.

Under CTA 2010 s 1026 (distribution following a bonus issue), for UK tax purposes the repayment of capital would have been considered a taxable distribution but, as he was a non-resident, ITA 2007 s 811 prevented UK income tax from actually accruing to the shareholder.

Companies registered overseas

The main issue with the demerger of a company registered overseas is that its corporate governance falls under foreign corporate law provisions, so a demerger will not be carried out under UK legal principles. In particular, the corporate law of many jurisdictions includes provisions that allow a company to demerge as a single legal step, literally allowing it to split up into two or more new companies.

To provide a UK tax analysis of the demerger, it is necessary firstly to understand the operation of the foreign company law, and then apply UK tax principals thereto. The problem for us is that UK tax law is written specifically with UK corporate law in mind, and the precise wording of the CGT reliefs that we rely on for a tax-efficient demerger may not be wide enough to cover the actual legal mechanism for the demerger. This is particularly an issue where a single-step demerger is allowed under foreign company law, as such a concept has simply not been envisaged in the drafting of UK tax law.

See example 2.

Real life example 2: companies registered overseas

A UK resident held shares in a listed overseas company which had carried out a demerger, under which shares in a new listed company were received.

We analysed the local corporate law, and identified that it included provisions that allowed a single-step demerger, which on initial review appeared to be a scheme of reconstruction under TCGA 1992 Sch 5AA, such that the shareholder may have been entitled to relief.

However, further research identified that the company had not in fact carried out the demerger in this form. From the steps described in public documents with the local stock exchange, it appeared that following a restructuring within the group, the shareholder ultimately received the new shares as a distribution in specie, and its receipt should therefore be taxed as a foreign dividend.

It is also worth noting that just because a company is registered overseas does not necessarily mean that

UK stamp duty is not due if the demerger involves a transfer of its shares. This is because stamp duty is a tax on documents (transfer instruments) that transfer interests in stock or marketable securities (a) executed in the UK or (b) relating to property or any matter or thing to be done in the UK (Stamp Act 1891 s 14(4)). Addressing the risk of any technical charge to stamp duty can be an important consideration in these transactions.

Non-resident companies

Where the company carrying out the demerger is resident outside the UK, we must look not just at the company's UK and foreign tax position, but also the consequential impact on UK shareholders.

UK shareholder tax

An oft-missed point is that under ITTOIA 2005 s 402, income tax is limited to a charge on 'dividends' from a non-UK resident company. This has a narrower scope than ITTOIA 2005 s 382, which charges income tax on 'dividends and other distributions' from UK-resident companies. Consequently, the provisions of CTA 2010 Part 23 (company distributions) generally will not apply in determining the shareholders' tax. In addition, if the demerger of the non-resident company involves a distribution which does not constitute a dividend (or which is a dividend of a capital nature), it should not be subject to income tax, and CGT reliefs may therefore be available.

Where the non-UK resident company is registered outside the UK, it is necessary to review the legal mechanism by which the demerger is to be undertaken, to assess whether the receipt by the shareholder is a dividend of an income character. Under the principles established by *Rae (Insp of Taxes) v Lazard Investment Company Ltd* [1963] UKHL 7, it is then necessary to consider whether the shareholder has received a dividend under local proper law (i.e. not tax law). It is therefore necessary to seek local legal advice as to the precise legal nature of each step of the proposed transaction. The recent FTT case of *Beard v HMRC* [2022] UKFTT 129 (TC) confirmed this principle, in that it sought to interpret the Jersey Companies Act, and it found that a distribution out of a share premium account was income, due to the legal mechanism used, which was not a capital reduction.

Shareholder's foreign tax

It is also important to confirm that no step in the transaction triggers a local tax charge for the UK shareholder, whether that be a direct tax or withholding tax; or, in the case of a dual-taxed shareholder, whether they may be subject to foreign tax elsewhere (for example, as a US citizen).

UK company tax

Generally, we might expect a non-resident company to be outside the scope of UK tax, but it is important to check that it has no UK assets or trade that could give rise to a UK permanent establishment. Where the company is within the scope of UK corporation tax (because it has a UK branch or UK property), it will be necessary to consider to what extent reliefs may remain available if the demerger involves a transfer of those assets between non-resident companies. For example, as a general rule, we might expect TCGA 1992 s 171 (transfers within a group) to continue to apply, providing the asset remains within the scope of the charge to corporation tax on capital gains in the hands of the transferee.

Foreign company tax

It is also important to confirm that the transaction does not crystallise local taxes for the company that is disposing of assets in the course of the demerger steps. In practice, using a local legal mechanism for the demerger may not create a local tax liability, as some jurisdictions seek to support business by providing a tax-neutral demerger route. However, it can on occasion be difficult to find a demerger method that is tax-neutral across both jurisdictions and for all parties.

UK companies with overseas assets and trade

For UK companies with overseas interests, the most important point is to confirm the foreign tax position for any foreign assets that may be transferred at some point through the transaction. Local tax advice is therefore required.

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Cross-jurisdictional demergers

In theory, nothing prevents a UK company from demerging assets into an overseas company (or vice-versa). However, from a UK tax perspective, not all reliefs may remain available. For example:

- Statutory demerger options for the shareholders will not be available, as they require all relevant companies to be UK tax resident.
- Relief for the disposal by the company of its chargeable assets under s 139 requires that the assets are transferred to a company that is resident in the UK – although we note that the substantial shareholdings exemption may still be available.

In practice, if a tax-neutral (or close to tax-neutral) cross-jurisdictional demerger can be achieved, then when requesting HMRC clearance, additional care should be taken to properly set out the commercial rationale for the jurisdictional change of registration and/or residence.

Mixed groups with mixed shareholders

By far the most interesting cases, at least for the authors, are those that involve multiple jurisdictions for both companies and shareholders. Balancing the various multiple jurisdictional tax issues can certainly be challenging. For example, if the pre-demerger restructuring includes something that constitutes a distribution from an overseas company to a UK company (i.e. a distribution in specie, or release of intra-group debt), the dividend exemption rules within CTA 2009 Part 9 will need to be considered. In particular, a small company will not be eligible for exemption on a distribution it receives from a subsidiary in a non-qualifying territory. See example 3.

Real life example 3: mixed groups with mixed shareholders

An overseas company owning a number of business interests around the globe is owned by three shareholders, each resident in a different jurisdiction. They wished to separate their interests and go their separate ways, but no single form of demerger worked for all three shareholders.

Independently of the other shareholders, a scheme of reconstruction was carried out funded by a repayment to the UK shareholder of all his capital – in consideration for which the company transferred some of the business interests to a new UK company, in consideration for which the new company issued shares to the shareholder.

For the UK shareholder, the tax analysis closely resembled that of a CRD, and no UK or foreign taxes accrued to any company. The other shareholders were able to then separate their interests using a different method.

Obtaining HMRC clearance did raise questions, but once it was accepted that fundamentally it was akin to a CRD, and being carried out for wholly commercial reasons, the clearance was forthcoming.

One key point to remember is that where the plan is to partition ownership of the underlying assets (i.e. each ownership is also separated between the shareholders), it may be possible to carry out demergers in different forms for different shareholders.

Other points

Demerging investments

It is important to appreciate that for there to be a scheme of reconstruction under TCGA 1992 Sch 5AA, there must be a separation of two businesses. So, if the assets to be demerged (or left behind) consist of little more than cash or passive investments, relief under either s136 (for the shareholder) or s 139 (for the company) may be denied.

Although this is strictly an issue with all indirect demergers, it does seem to arise more frequently with overseas companies.

HMRC does accept that a single property interest is sufficient to constitute a business for this purpose. It has also issued guidance that explains that for an investment portfolio to be a business, it needs to be actively managed by the company and not a third-party broker.

Other impacts

It will also be important to assess whether the demerger impacts upon the availability of tax attributes (such as tax losses) for the company whose trade or business is split and the company that is in receipt of that trade or business.

Conclusion

Demergers are an important and common type of transaction for companies throughout the world. International aspects do complicate matters and need very careful consideration, but with appropriate international assistance, solutions can usually be found. ■

For related reading visit taxjournal.com

- Statutory demergers (C Holmes & B Handley, 26.3.21)
- Miller's tales: demergers by distribution (P Miller, 10.11.21)
- How to handle tax on corporate reconstructions (P Townson & C Holmes, 5.11.19)