Analysis

Section 77 stamp duty relief and company reorganisations

Speed read

The FA 2016 had an unpleasant surprise in the form of the introduction of an additional requirement for s 77 stamp duty relief on a share-for-share exchange. The amendment is intended to tackle stamp duty planning, but it also impacts genuine commercial transactions where there is no question of tax avoidance. In particular, one result of the amendment is to impose an extra cost where shareholders wish to partition a property company using the reduction of capital procedure – a transaction hitherto thought uncontroversial.

Michael Collins
Temple Tax Chambers
Michael Collins is a barrister who practices at Temple Tax Chambers. He advises and litigates in all areas of tax, including stamp taxes and company reconstructions. He has been one of the editors of *Taxation of companies and company reconstructions* since 2006. Email: mc@templetax.com; tel: 020 7353 7884.

The progress of the FA 2016 had an unpleasant surprise for practitioners in company taxation. The tightening of the transactions in securities provisions and the targeted anti-avoidance rule for close company liquidations had been widely trailed. But at committee stage, and without any prior consultation, the government tabled an amendment to FA 1986 s 77.

Most practitioners will be familiar with s 77. It is the means by which a new holding company can be inserted above an existing company without incurring a charge to stamp duty. The new holding company (referred to in the legislation as 'the acquiring company') acquires the shares in the existing company ('target') and in exchange issues shares to the shareholders in target. Provided the shareholders and their shareholdings in the acquiring company mirrored those in target, and the exchange was for commercial reasons and had no tax avoidance main purpose, the acquisition of the shares in target was exempt from stamp duty.

What's changed?

The amendment to s 77 (new s 77A) disapplies relief where there are 'disqualifying arrangements' in existence at the time of the share-for-share exchange. Arrangements are disqualifying if it is reasonable to assume that the purpose, or one of the main purposes, is to secure that a particular person or persons together obtain control of the acquiring company.

Exceptions

There are two exceptions. The first covers a change in control of the acquiring company which is brought about as a result of the share-for-share exchange. So, for example, if the acquiring company was formed with one subscriber share issued to X, an issue of shares to X and Y as consideration for the acquisition of the target company would not trigger s 77A, even if it results in Y obtaining control of the acquiring company.

The second exception is for 'relevant merger arrangements'. This exception is directed at the unusual case where at the time of a share-for-share exchange there are arrangements for the acquiring company to acquire a second company by means of another share-for-share exchange. If the second share-for-share exchange results in a change in control of the acquiring company, s 77A will not apply to disapply relief on the first share-for-share exchange, provided the second share-for-share exchange meets the requirements of new s 77A(4).

The reason for the change

The purpose of s 77A is not easy to determine. The tax information and impact note which HMRC published when the amendment was tabled says the policy objective is to prevent 'an unfair tax advantage where share for share relief is claimed in takeovers. HMRC [has] identified transactions which lead to this unfair outcome and is taking action.' However, the planning that HMRC has in mind is not described in the impact note, nor has it been included in HMRC's 'spotlights'.

It has been speculated that the amendment is directed at a takeover of a UK-resident company by a Jersey-resident company in advance of a sale of the Jersey company to a third-party purchaser. If the instrument transferring the shares in the Jersey company is executed outside the UK, it will be outside the scope of stamp duty and SDRT. Provided the takeover was for commercial reasons and had no tax avoidance main purpose, it would have been exempt from stamp duty under s 77. Rather than having to argue over the commercial and tax avoidance requirements, HMRC has introduced s 77A to disapply relief on the takeover where the sale was pre-arranged.

If s 77A appears to be a case of a sledgehammer being used to crack a nut, it was pointed out to HMRC during the progress of the Finance Act that s 77A would affect also genuine commercial transactions where there was no question of a tax advantage.

A particular area of concern is where a new holding company is being inserted above an existing company as a preliminary step to a reorganisation of the company's business. Readers who advise on company reorganisations will be familiar with this practice. Where a liquidation/Insolvency Act 1986 s 110 reorganisation is proposed, a new holding company is advantageous because it means the existing company can remain in place and a clean company reduces the time and costs of the liquidation. Where a reduction of capital reorganisation is used, a share-for-share exchange inserting new holding company is usually necessary to achieve a step up in share capital, which can then be reduced and repaid to the shareholders *in specie* by a demerger of part of the business. This works because in consideration for the acquisition of the shares in target, the new holding company can issue shares with share capital equal to the value of the shares in target. In both cases, clearance is normally given by HMRC for capital gains reliefs both for the preliminary share-for-share exchange and the reorganisation.

Reconstructions and partitions by liquidation

The good news is that s 77A should have no impact on a share-for-share exchange in advance of either a

liquidation or a reduction of capital *reconstruction*. 'Reconstruction' is here used to describe a reorganisation where the ultimate ownership of the business stays the same. Section 77A will not apply because there would normally be no change in control of the acquiring company/Holdco in a reconstruction. An exception to this is if it is arranged that after a reduction of capital reconstruction the shareholders would give away or sell the shares in Holdco to a particular person or persons.

Also unaffected by s 77A is a share-for-share exchange in advance of a partition (where the business of the company is split between the shareholders) which takes place by liquidation. Section 77A does not apply because a particular person or persons together does not 'obtain control of' Holdco. The definition of 'control' for this purpose refers to the power to secure that the affairs of the company are conducted in accordance with the person's wishes. A liquidation of Holdco results in the shareholders losing control, but the liquidator does not obtain control because he must conduct the affairs of the company in accordance with the insolvency regime and not his own wishes. HMRC has confirmed that this is its view, but it is taking further advice.

Partitions by reduction of capital

If most reconstructions and liquidations are unaffected by s 77A, the same cannot be said if the shareholders choose to partition the company by way of a reduction of capital using the steps described in figure 1 and there is a change in control of Holdco. A change in control will not normally take place if there is a majority shareholder (or group of shareholders) in the company who ends up with control of Holdco. This is discussed further below. But if the shares in the company are held 50:50 and no shareholder has control (as in figure 1) then s 77A would apply. In that example, A and B wish to partition the business of Mixco so that A controls the let properties and B controls the trade. Before 29 June 2016, the only charge triggered by the partition was stamp duty on the transfer of the shares in Mixco to Newco. Now relief on the preliminary share-for-share exchange is disapplied because arrangements are in place for the cancellation of the 'B' shares in Holdco which result in A obtaining control of Holdco. This means stamp duty on the value of the Holdco shares issued at step 1, as well as on the transfer of the shares in Mixco to Newco. Quite what the rational policy objective is of imposing an additional cost for a reduction of capital partition in these circumstances but not a liquidation partition is impossible to determine.

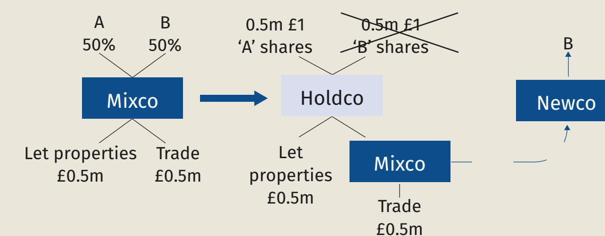
What can be done?

Where the business of the company is trading, or part trading and part property investment, a solution will often be to use a liquidation/s 110 partition rather than a reduction of capital. However, this will be of no assistance in the case of a wholly property investment company which neither shareholder controls. In such a case, a liquidation partition will give rise to a full rate SDLT change on the transfer of the let properties to Newco A (see figure 2).

It may be possible to secure s 77 relief where a reduction of capital is used by having a share sale in advance of the partition, so that one shareholder obtains control of the company. Provided the controlling shareholder ends up with control of Holdco, there would be no change in control so s 77A would not apply. So, for example, in figure 1 if B transferred one share in Mixco to A before the share-for-share exchange, A would be in control of Holdco immediately after the share-for-share exchange and thereafter and s 77A could have no application. The GAAR does not apply to stamp duty and it is considered that such a transaction could not be attacked by a purposive construction of s 77A because for the reasons already mentioned that purpose, at least in the context of reorganisations, is impossible to determine.

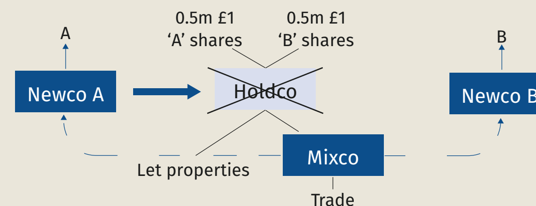
However, a preliminary share sale is only likely to be of assistance where the shareholders are spouses (so that the spouse exemption applies) or where there is little or no gain on the shares so that the capital gain tax on the share sale does not exceed the stamp duty charge on the share-for-share exchange. In other cases, the unfortunate consequence is that where shareholders wish to partition a property investment company in circumstances where there will be a change in control of the acquiring company, s 77A has imposed an extra cost for a transaction which previously was thought uncontroversial. ■

Figure 1: Reduction of capital partition of a 50:50 company



Steps:
1. Insert new Holdco by a share-for-share exchange.
2. Hive up let properties from Mixco to Holdco.
3. Reorganise the shares held by A into 'A' shares and those held by B into 'B' shares.
4. Reduce capital on the 'B' shares. Repay capital in specie by transferring Mixco to Newco B which issues shares to B. The 'B' shares in Holdco are then cancelled.

Figure 2: Liquidation/s 110 partition of a 50:50 company



Steps same as in figure 1 except that after the reorganisation of the shares, Holdco is liquidated and, pursuant to a s 110 agreement, the let properties are distributed to Newco A in return for an issue of shares to A, and Mixco is distributed to Newco B in return for an issue of shares to B. The transfer of the let properties to Newco A is subject to a full rate SDLT change on the value of the shares issued to A.

- Stamp duty relief: the problems with section 77 (Heather Corben & Adrian Brettell, 12.11.15)
- The new section 179 and reconstructions (Michael Collins, Philip Ridgway & Richard Bramwell, 28.7.11)