

The SSE: where are we now?

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What is the SSE?

The SSE exempts companies from corporation tax on gains arising on the disposal of a substantial shareholding in another company.

Interestingly, when the legislation was introduced, the draftsman was concerned to ensure that companies were not able to engineer disposals to fall outside of the SSE when they generated a capital loss, thus having the best of both worlds. This concern explains some of the complexity in the legislation.

Before 1 April 2017, the SSE applies if:

- the “investing company” (the company making the disposal) has owned a “substantial shareholding” in the “investee company” (the company whose shares are being disposed of) for a continuous twelve month period in the two years (the “qualifying period”) before the disposal;
- the investing company is a trading company or a member of a trading group throughout the qualifying period and immediately after the disposal; and
- the investee company is a trading company or a holding company of a trading group or a trading subgroup throughout the qualifying period and immediately after the disposal.

Assuming the Finance Bill is enacted, the qualifying period has been extended to six years and the requirement that the investing company is trading has been removed for disposals on or after 1 April 2017. In addition, whilst the trading condition for the investee company is being retained, the

investee company is no longer required to trade immediately after the disposal except where:

- the disposal is to a person connected with the investing company; or
- the trade has been transferred into a new company within the previous 12 months.

The trading condition

According to HM Treasury, the policy objective of the SSE is to ensure that the tax treatment of share disposal gains does not discourage trading groups from restructuring or making productive disposals. However, confirming that this trading condition is satisfied has often not been straightforward and it is this requirement that causes the most issues in practice.

A trading company is “a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities”. A “substantial extent” is not defined. HMRC considers this to mean more than 20%; therefore if a group’s non-trading activities amount to more than 20% of its total activities (excluding intra-group or intra-subgroup activities) the group does not meet the trading requirement. There is, however, no legislative or case law basis for this “20% test”.

HMRC’s guidance raises more questions than it answers. For example, it indicates that the “20% test” must be applied to turnover, the value of assets and expenditure incurred or time spent by officers and employees on non-trading activities. What is not made clear is the consequence of failing, say, one of the three tests.

Determining whether a group or subgroup represents a trading group or subgroup is a complex exercise. It often requires a significant amount of time examining and evaluating a group's assets and balance sheets. Some groups may, for good reasons, have significant retained cash, valuable assets (such as brands) that are not shown on its balance sheet or assets that have previously been used in its trade but which are now surplus to requirements. In many situations there is a general feeling that the trading condition should be met but, on a detailed analysis, sufficient uncertainties arise to necessitate discussions with HMRC.

It is therefore good news that the trading conditions have been relaxed from April 2017, as this should simplify the SSE regime and reduce the administrative burden on businesses and HMRC. The complexity of the trading condition still needs to be tackled in respect of the investee company (unless the institutional investor provisions discussed below apply), which may make the SSE less straightforward than the participation exemption in other holding company jurisdictions.

Twelve month ownership

In some ways, the qualifying period is an anomaly. The dividend exemption does not have a twelve month holding condition. Why should dividends be able to be taken out immediately tax free but any disposal of shares needs to wait for twelve months? Should it not be sufficient that the shares are held as a capital, rather than a trading, asset?

The extension of the qualifying period from two to six years will assist companies who sell-down shareholdings in tranches; previously, if a sale took a company's shareholding below 10%, the remaining shares would need to be sold within a year to remain within the SSE. Now the seller has five years.

A more significant change for practitioners is the Finance Bill amendment to TCGA 1992 Sch 7AC para 10. This small but important amendment will

help in the relatively common situation where a multinational group needs to transfer a shareholding from a non-UK subsidiary to, say, the UK parent company, before the onward disposal of the shareholding, perhaps as part of a spin-off or demerger. If the UK parent does not hold the shareholding for a year before the on-sale, does the SSE apply? If not, even though the UK parent will acquire a market value base cost in the shareholding, it is still exposed to tax on fluctuations in the value of the shareholding, perhaps arising due to foreign exchange movements.

Paragraph 9 Sch 7AC treats a company as holding any shares held by any other company in its worldwide group. This would apply where, for example, a UK member of the group holds only 5% of the shares of a company but the remaining 95% is held by other members of the group. In our view, para 9 also means that the UK parent could rely on the ownership by the non-UK subsidiary to meet the twelve month requirement

HMRC's view on this point has been inconsistent, but it has been known to argue that para 9 is not intended to apply to satisfy the twelve month requirement. This point should, however, become otiose, as para 10, which currently states that the qualifying period can be extended to include ownership by members of the group prior to an intra-group transfer, is being amended to confirm that ownership by non-UK members of the group will also satisfy this requirement.

Qualifying institutional investors

A glance at the Finance Bill shows that the majority of the provisions in respect of the SSE have nothing to do with the above changes, but concern the introduction of a new relief for companies owned by institutional investors. These changes will have a narrower application, but are designed to promote the UK as "a place where global investors can establish and manage their investments in trading businesses, infrastructure projects and real estate".

The exemption is designed to equalise the difference in treatment of a disposal by, for example, a sovereign wealth fund or pension fund of a direct shareholding (which, because of their tax exempt status, would be exempt) and the disposal by a UK holding company in which such funds invest (which may be taxable due to the presence of substantial non-trading activities in their groups).

For disposals on or after 1 April 2017, the SSE will apply to disposals of substantial shareholdings by companies in which 80% of the ordinary share capital is held by qualifying institutional investors (QIIs, which include registered pension schemes, life assurance companies, sovereign wealth funds, charities and investment trusts) even if the investee trading test is not met. A proportionate part of the gain or loss will be exempt if QIIs own between 25% and 80% of the ordinary share capital of the investing company. Furthermore, even if the shareholding held by the investing company in the investee company is less than 10%, the exemption may still be available if the shareholding was acquired for £20m or more.

Hive-out transactions

The Finance Bill changes have not solved all of the SSE's niggles.

Finance Act 2011 introduced some useful changes to deal with the situation where a group wanted to sell one of two trades carried on in a subsidiary. Previously, in order to rely on the SSE, it would have been necessary to transfer the trade that was to be retained to another group company before selling the subsidiary. This might have been difficult to implement or commercially unacceptable, and there was no policy reason why the SSE should not apply even if it were the business being sold that was hived out.

Since 2011, it is possible to hive the business being sold to a NewCo and then sell the NewCo, because: (a) the period over which a parent is treated as holding shares in the NewCo that acquires the

business to be sold is extended to include the period for which the assets transferred were used by the group in a trade (so that the qualifying period condition is satisfied in respect of the NewCo shares); and (b) the TCGA 1992 s179 degrouping charges that arise on the transfer of the business to NewCo are treated as additional consideration for a disposal in the hands of the seller, and so should be exempt under the SSE.

Practitioners will know that satisfying these conditions can raise difficulties. In practice, commercial necessities can be difficult to align with the requirement that NewCo must be beneficially owned by the group at the time of the transfer (so that the hive-out qualifies as an intra-group transfer) and that NewCo must begin carrying on the trade before the disposal of the NewCo shares. It is also worth noting that the s179 charge is not avoided if NewCo leaves the CGT group due to, for example, an issue of new shares.

Earn-outs

When a company sells shares and receives a right to a cash earn-out as part of the consideration, there are two chargeable disposals to consider:

- a disposal of shares for consideration equal to the sum of (i) the cash received at the time of the share sale, and (ii) the fair value, at that time, of the right to receive the earn-out payment; and
- a disposal of the right to receive the earn-out consideration, which takes place at the time at which the earn-out consideration is paid.

If the transaction qualifies for the SSE, any gain or loss on the first disposal will be exempt under the SSE. However, any gain or loss on the second disposal will not be exempt under the SSE, as it is not a disposal of shares. It can come as a surprise to discover that there is a tax charge arising from what was understood to be a tax exempt disposal.

Share for share transactions

Although both result in tax neutral disposals, it still matters whether the share for share exchange provisions (TCGA 1992 s135) or the SSE applies to a transaction, because, for example, the twelve month holding period starts to run again following an SSE disposal.

The SSE consultation would have been a perfect opportunity to simplify the complicated interaction between s135 and the SSE. There is no policy logic in the current position, whereby the SSE trumps s135 unless the transaction is within a CGT group, in which case s135 trumps the SSE and TCGA 1992 s171. It could also be argued that gains deferred under section TCGA 1992 s140 are brought

into charge on a share for share exchange because the “no disposal” fiction is disapplied by Sch 7AC para 4(3). Paragraph CG53170A of the HMRC’s Capital Gains Manual is clear evidence that this is an area ripe for simplification!

Conclusion

The Finance Bill changes to the SSE are to be welcomed, particularly the relaxations in the trading requirements and, for those that benefit, the extended exemption for qualifying institutional investors. There are, however, still pitfalls for the unwary.

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