Demergers – Liquidation Reconstruction under s 110 Insolvency Act 1986

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INTRODUCTION

Companies are increasingly turning to demergers as a method of separating out various parts of a business. The decision to split off a trade or subsidiary from a company or group may be undertaken for a multitude of reasons including streamlining operations, ring-fence liabilities, succession planning or shareholder disputes.

There are three broad routes to carrying out a demerger:

1. The statutory route (an exempt demerger)
2. Liquidation under the Insolvency Act 1986
3. Reduction of capital (a Companies Act 2006 reconstruction)

This note focuses solely on the liquidation route, covering the key tax implications and the principal qualifying requirements.

Part 1 and Part 3 of this demerger series focus on demergers under the alternative routes of (1) a statutory demerger and (2) a reduction of capital demerger.

A liquidation demerger is an alternative to a statutory demerger where the requirements of the latter cannot be met. In practice there are two main reasons why a statutory demerger is not possible, either because there are companies in the group that are not trading companies, or because the demerger is in anticipation of a sale of one or more of the companies involved in the demerger.

BASIC STEPS

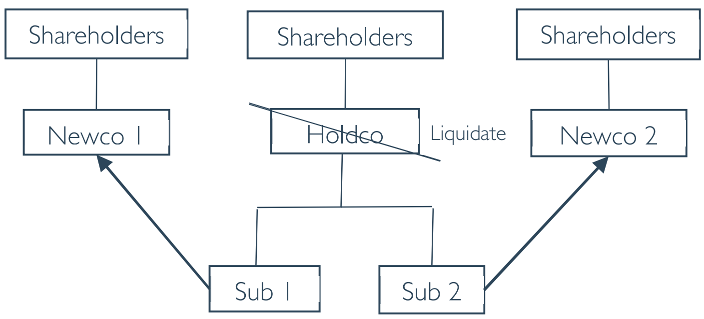
In order to outline the basic mechanics, assume a holding company with two subsidiaries, and there is one shareholder who is a UK resident individual. The shareholder wants to separate the two subsidiaries so that each is held independently of the other. The requirements for a statutory demerger are not met.

The basic steps to effect a liquidation demerger would be as follows:

1. The shareholder forms two new companies with a small number of subscriber shares;
2. The holding company appoints a liquidator who enters into a tripartite agreement with the shareholders and the two new companies in which it is agreed that the liquidator will distribute the shares in a subsidiary to each of the new companies, and those companies will issue new shares to the shareholder as consideration for the transfer of shares in the subsidiaries.
3. Having distributed all the assets of the holding company in the course of the liquidation, the holding company is struck off the register at Companies House.

As a result, the shareholder holds all the share capital of two new holding companies, each of which holds all the shares in one of the subsidiaries.

Although there are various taxes to consider in relation to these transactions, by effecting the demerger in accordance with the statutory provisions, no tax liabilities should arise in the above situation.



VARIATIONS ON THE DEMERGER STEPS

Innumerable variations on the basic liquidation demerger model are possible, so as the deal with specific situations. In every case the tax position would have to be considered to ensure that tax liabilities are mitigated as far as possible.

Where the holding company has a number of shareholders, they may want to separate subsidiaries into different ownership. This is referred to as a partition. It is still possible to avoid most of the potential tax charges apart from stamp duty, which would be payable at ½% on the value of the shares issued in each of the new companies as consideration for the companies they acquire.

There may not be a holding company, but instead the top company in the group carries on its own business. This means that it may not be feasible to put that company into liquidation. One solution would be to put a new holding company over the existing top company by way of a share for share exchange, and then transfer some or all of its subsidiaries under the new holding company. The group would then be in a position to effect the liquidation demerger.

Assets can be transferred between group companies in preparation for the demerger. This needs to be done with care to ensure that a corporation tax charge does not arise. Where land and buildings are transferred, there could also be an SDLT charge depending on how the transfers take place.

Whenever a liquidation reconstruction is being considered it is vital that each of the steps is considered carefully to ensure that all potential tax issues are addressed. This is usually done by preparing a detailed steps plan, which also ensures that all parties understand what is involved and what documentation or agreements are required from the start.

CLEARANCE APPLICATION

A clearance application will be required to ensure that HMRC are satisfied that the demerger is being done for bona fide commercial reasons and not for the avoidance of tax. If they are not satisfied, the shareholders will be treated as having made a chargeable disposal of their shares in the holding company, based on the market value of the assets transferred by the liquidator to the new companies.

CONCLUSION

A liquidation demerger is a useful alternative to a statutory demerger when the detailed requirements of the latter cannot be met. However, the steps must be considered carefully to ensure that there are no unexpected tax liabilities. It is usually possible to effect a liquidation reconstruction with little or no tax liabilities arising.

However, sometimes the shareholders do not want to be involved in a liquidation because of commercial or reputational reasons, so alternatives need to be considered, such are a capital reduction demerger.

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