Some good news after all - reforms of the UK substantial shareholding exemption

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The substantial shareholding exemption (SSE) in its current form broadly exempts from corporation tax capital gains realised on the disposal of certain substantial shareholdings, provided certain prescriptive conditions are met. Following criticism that the SSE was unduly complex and its applicability too narrow when compared to equivalent exemptions in other jurisdictions (*e.g.*, Luxembourg, the Netherlands), thereby affecting the UK's competitiveness as a holding company jurisdiction, a consultation on the reform of SSE was launched by the UK government in May 2016. As a result of that consultation, it was confirmed in the 2016 Autumn Statement that changes would be made to simplify the SSE regime by removing certain complexities and administrative burdens associated with the current application of the exemption. On December 5, 2016, proposed legislation was published in the draft Finance Bill 2017 alongside a response to the consultation.

Although the changes may not be as sweeping as one may have hoped and the adoption of a broader participation exemption was rejected, they still represent a significant step forward and the simplification of the rules is certainly welcome.

Why change?

While the UK government believes that the UK tax regime has a number of features which make it attractive as a holding company jurisdiction (*e.g.*, no withholding tax on dividends, broad exemptions from tax on the receipt of dividends and one of the most extensive tax treaty networks in the world), it is aware that the existing SSE regime is more complex, and its application more narrow, in comparison to equivalent exemptions in other jurisdictions. The trading requirements also mean that SSE is not generally available to institutional investors which carry on real estate investments. The UK government also views the OECD's Base Erosion and Profit Shifting project (BEPS) as creating an opportunity for the UK to attract further inward investment, and by widening the scope of SSE, it will increase UK's attractiveness as a holding company location for groups with substantial investment activities and may alleviate the risk of UK headquartered groups relocating out of the UK.

Current SSE regime

In broad terms, SSE is currently available to a company that makes a disposal (an investing company) of shares in another company (an investee company) provided that the following conditions are met:

- the substantial shareholding requirement − the investing company holds at least 10 percent of the ordinary share capital in the investee company throughout a continuous period of twelve months (beginning not more than two years prior to disposal)

- the trading requirement for the investing company − the investing company must either be a sole trading company or a member of a trading group throughout the "qualifying period" (*i.e.,* beginning with the start of the 12-month period for which the substantial shareholding requirement was met) and immediately after the disposal and
- the trading requirement for the investee company - the investee company must be a trading company or the holding company of a trading group/subgroup throughout the qualifying period and immediately after the disposal.

Proposed changes

The following changes, as set out in the draft Finance Bill 2017, will apply to disposals on or after April 1, 2017.

Removal of the trading requirement for the investing company

From April 1, 2017, the availability of SSE will no longer depend upon the investing company meeting the trading requirement - *i.e*., it will not need to be met either before or immediately after the disposal. This removes the uncertainty often involved in determining whether the investing company is indeed part of a trading group, especially in the context of a large worldwide group where it could be burdensome to obtain all the relevant information and the definition of trading is not clear-cut.

Removal of the post-disposal trading requirement for the investee company

The condition that the investee company (*i.e*., the company in whose shares are sold) needs to be a trading company or a holding company of a trading group/subgroup immediately after a disposal will no longer apply, unless the disposal is to a connected company. This will improve the certainty of the availability of the SSE in situations where the selling company has no control over, or knowledge of, the activities of the investee company once it has been sold to a third party.

Extension of the 12-month holding requirement in the 2-year period prior to disposal to a 6-year period

It was highlighted in the consultation that the requirement for the investing company to have held a substantial shareholding (*i.e.,* at least 10 percent of the ordinary share capital in the investee company) for a continuous 12-month period in the two years prior to disposal led to [GK1] distortions of business decisions. This is particularly problematic in situations where a group has to dispose of a substantial shareholding in tranches over a long period of time (*e.g.,* it is unable to find a buyer to acquire the entire shareholding).

This two-year period will be extended to six years from April 1, 2017 onwards, such that once the investing company's shareholding in the investee company falls below 10 percent, it will have a five-year period within which the remaining shareholding can be sold with no UK corporation tax on any gains.

New exemption for companies owned by qualifying institutional investors

While certain institutional investors, such as pension funds, are generally exempt from UK corporation tax on gains, if they hold their assets via UK resident companies for other commercial and legal reasons, those UK companies are prima facie subject to corporation tax on any gains from share disposals and cannot generally avail themselves of the SSE due to the trading requirements discussed above.

To address this concern, instead of removing the trading requirement for the investee company in its entirety, the UK government will introduce a new exemption for investing companies that are owned by "qualifying institutional investors" (which includes pension schemes, life assurance businesses, sovereign wealth funds, charities, investment trusts and widely marketed UK investment schemes (such as authorised investment funds or exempt unauthorised unit trusts that meet the genuine diversity of ownership condition). It is worth noting that not all types of UK funds are included in the definition of "qualifying institutional investors" − real estate investment trusts (REITs) will not benefit from this new exemption but the UK government will continue to consider whether there is a case for including REITs within the definition.

In broad terms, the new exemption would exempt a gain on the disposal of a "substantial shareholding" in any company even where the trading requirements are not met, provided that immediately before the disposal, 80 percent or more of the ordinary share capital of the investing company is owned by qualifying institutional investors. If the investing company is owned as to 25 percent - 80 percent by qualifying institutional investors, the amount of chargeable gain is reduced by the percentage of the ordinary share capital in the investing company that is owned by qualifying institutional investors. Ownership can be direct, indirect ownership or a combination of the two, though in the context of indirect ownership, the intermediate company cannot be listed on a recognised stock exchange.

For the purposes of this new exemption, the definition of "substantial shareholding" will be extended such that even if the investing company does not hold 10 percent of the ordinary share capital in the investee company, the exemption could still apply provided that (i) the investing company's acquisition cost in the investee company was at least £50 million; and (ii) the investing company must be beneficially entitled as against other shareholders to a proportionate percentage of income distributions and to assets on a winding up.

Other issues

As identified in the consultation process, there are other technical areas surrounding the application of the SSE that currently present challenges to businesses. These include (i) the focus on ordinary share capital is overly restrictive and excludes entities without ordinary share capital or partnerships from the scope of the SSE; (ii) the definition of trading activities remains unclear; (iii) difficulty as regards the joint venture rules in the SSE context; and (iv) the availability of the SSE under earn-out arrangements. Unfortunately, the UK government has not taken the opportunity to address these issues at this stage and thus a certain level of uncertainty remains.

Conclusion

While some may consider that the reforms to the SSE regime are not far-reaching and comprehensive enough compared to regimes available in other EU countries, nevertheless the proposed reforms will broaden the scope of the SSE by removing some of the complexities and uncertainties surrounding its application, thus potentially improving the UK's attractiveness as a holding company location.

Against the backdrop of the fundamental changes being made to the international tax landscape, particularly as a result of the final recommendations of the BEPS Project, coupled with the uncertainties of the impact of Brexit on the UK economy, the proposed reforms to the SSE regime are certainly welcome.