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DEMERGERS AND TRUSTS: FURTHER THOUGHTS

Julian Ghosh[1]

Christopher McCall QC in his very helpful article "Demergers and Trusts" (PTPR Vol 1, 1991/92, Issue 3, 199) raised a number of issues which concerned the treatment, both in trust law and fiscally, of a demerger governed by ICTA 1988 s.213.

This paper seeks to offer some further thoughts on one specific question, namely, what is the CGT position of a beneficiary with an interest in possession in a trust holding shares in a company which effects a s.213 demerger. (Quaere whether the implications outlined below will also hold true for discretionary trusts when the income is mandated to a beneficiary.)

Incidentally, it appears that Scots law follows its English equivalent in this area of trust law. It will be recalled that English law deems a life tenant of a simple English trust as entitled to trust income as it arises (*Baker v Archer-Shee* [1927] AC 844); furthermore, shares in a transferee company (to use s.213 terminology) dividended in specie under a s.213 demerger are treated as income to which the life tenant is entitled (*Hill v Permanent Trustee Company of New South Wales Ltd* [1930] AC 720 (a Privy Council decision). Scots law follows this general rule; in *Forgies Trs v Forgie* 1941 SC 188 a special payment out of capital profits made on the day before the company went into liquidation was held to be an income payment due to the liferenter, not the fiar. Similarly, a special capital profits dividend paid in specie in the form of stock to another company was held to be income due to the liferenter in *Smith's Trustees v Graham* 1952 SLT (Notes) 23. One may with relative safety conclude that any fiscal consequences flowing from a s.213 demerger will hold true for Scots and English interest in possession trusts alike.

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1 Julian Ghosh LLB LLM, c/o Pump Court Tax Chambers, 16 Bedford Row, London WC1R 4EB
Tel: (071) 414 8080 Fax: (071) 414 8099
Contributor to the Customs & Excise section of Butterworth's *Stair Memorial Encyclopaedia* (forthcoming in 1993).
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S.213 Demergers: Mechanism and Effect

A classic s.213 demerger involves a "hive down" of the trade and assets of a company ("the distributing company") to a subsidiary ("the subsidiary company"). Thereafter, holders of shares in the distributing company receive additional shares in the transferee company as a dividend in specie.

S.213 affords exemption from distribution treatment for Schedule F purposes with no ACT liability on the distributing company.

The Reorganisation Provisions

TCGA 1992 s.192 is imported automatically into a s.213 demerger (s.192(2)). S.192(2)(b) applies ss.126-130 of that Act "*with the necessary modifications* ... as if that company and the subsidiary whose shares are transferred were the same company *and the distribution were a reorganisation of its share capital* ["that company" being the distributing company]" (emphasis added). This *mandatory* importation of the CGT reorganisation provisions clearly overrides any restrictions otherwise circumscribing their application, for which see *Dunstan v Young Austen Young Ltd* [1987] STC 709.

TCGA 1992 s.127 deems a reorganisation not to involve any disposal of the "original shares" or acquisition of the "new holding", with the original shares and the new holding being treated as a single asset "acquired as the original shares were acquired".

S.126 defines "original shares" as "shares held before and concerned in the reorganisation" and a "new holding" as, in relation to any original shares, "shares in and debentures of the company which as a result of the reorganisation represent the original shares (including such, if any, of the original shares as remain)".

So how does a s.213 demerger fit into the terminology of ss.126 and 127?

The short answer is with difficulty.

The reorganisation provisions in TCGA 1992 clearly do not envisage applying to a transaction where, rather than the share capital of a single company being altered or adapted, a distributing company spawns a new and distinct asset, namely the transferee company. However, to make sense of the *mandatory* application of the reorganisation provisions to a s.213 demerger, the shares of the distributing company ought properly to be viewed as "the original shares" before the demerger. The shares of the distributing company and the transferee company together constitute the "new holding" representing the original shares after the demerger. The "necessary modifications" phrase in TCGA 1992 s.192(2) permits such a view which necessarily requires violence to be done to the language of the reorganisation provisions to allow the accommodation of a s.213 demerger.

Interest in Possession Trusts: the Capital Gains Tax Position

On the demerger being effected, it may be argued that the shares of the transferee company become part of the trust fund to which the life tenant becomes absolutely entitled thereafter. This view would import a CGT charge under TCGA 1992 s.71.

However, the better view, on the basis of *Archer-Shee* in England and *Forgies Trs* in Scotland, is that the transferee company shares never become trust property. The trustees merely have a lien for costs which must be obtempered before the income shares become the absolute property of the life tenant. It follows that s.71 is not in point.

What however is the base cost of the income shares in the hands of the beneficiary? There are (at least) three approaches:

Market Value Apportionment

This appears to be the best view in law. As demonstrated supra, the shares in the distributing and transferee companies *must*, in terms of s.127, be regarded as a single holding acquired at a time when the shares in the distributing company were acquired.

Accordingly, assuming the distributing company is not wound up, the disposal of shares in the transferee company by the beneficiary who becomes entitled to them constitutes a part disposal and the base cost of the transferee company shares should be deemed to be a proportion of the base cost of the shares of the distributing company by reference to market value at the time of *disposal* (TCGA 1992, s.129). (S.129 applies if the transferee company is unquoted or, if quoted, the shares are of a single class; in any other case the base cost is calculated by reference to market value as at the first day on which market values or prices were quoted or published for the shares in question (whether that day is before or after the date when the reorganisation took effect) (s.130)).

The requirements of ICTA 1988 s.213(8) that the distributing company must retain at most only a minor interest in the trade transferred to the transferee company ensures that for single trade distributing companies virtually all of the base cost of the distributing company should be apportioned to the transferee company shares. Should the distributing company be wound up, the same market value apportionment rules would apply to the distributing company shares which in terms of s.126, constitute part of the new holding after the demerger has been effected. Trustees of interest in possession trusts should take note that shares in the distributing company may retain little or no base cost.

Valuation clearly becomes more complex if the distributing company is not a single trade company and retains trades other than that subject to the demerger. A sale of the transferee company shares by the beneficiary when the distributing company was still extant would require a valuation not only of those shares but also the distributing company shares retained by the trustees to make the market value apportionment. This may well prove to be a complicated and expensive exercise.

This analysis is unaffected by the fact that the trustees hold shares in the distributing company while the beneficiary with an interest in possession holds shares in the transferee company. The reorganisation provisions make no reference to any requirement that the original shares and new holding be held by the same person in order that they apply. Furthermore the status of the transferee company shares as income or capital in the hands of the beneficiaries is, in the light of the mandatory deeming mechanism of the reorganisation provisions, irrelevant.

Nil Base Cost

The Inland Revenue apparently take the view that the life tenant has a *nil* base cost in the transferee company shares. As far as the writer understands it, the basis for this approach is as follows:

(1) TCGA 1992 s.127 deems the s.213 demerger not to involve a disposal.

(2) The life tenant incurs no expenditure in acquiring the transferee company shares within the meaning of TCGA 1992 s.38 (base cost expenditure).

(3) TCGA 1992 s.17 (transactions not at arm's length deemed to take place at market value) cannot be prayed in aid. The application of s.17 requires a *disposal* to take place before the market value rules can be invoked to afford the beneficiary acquiring the shares a market value base cost.

(4) It follows that the transferee company shares base cost is nil.

(5) Presumably the distributing company shares retain their full base cost.

This analysis should be strongly resisted.

The reasoning imports the application of TCGA 1992 s.127 so that no disposal takes place on a s.213 demerger but assumes that ss.129, 130 (market value apportionment of base cost) do not apply. These provisions are specifically deemed to apply to a s.213 demerger by reason of s.192(2)(b). There is simply no basis in statute or logic for this partial application of the reorganisation provisions. The "non-application" of s.17 is irrelevant to the whole question.

Cash Value of the Dividend in Specie of the Transferee Company Shares

This view regards the base cost of the transferee company shares as the cash equivalent of those shares.

While achieving the most attractive result for the beneficiary (who effectively obtains a market value base cost) and indeed the trustees (who retain their full base cost in the distributing company shares), this view is suspect in principle and statute.

In order to obtain a base cost of the transferee company shares equivalent to the cash value of those shares, the beneficiary would have to establish that the shares were acquired for expenditure in money or money's worth amounting to that sum in terms of TCGA 1992 s.38. If this type of expenditure were established one would presumably seek to pray in aid *Stanton v Drayton Commercial Investment Co Ltd* 55 TC 286 to argue that the base cost was the price arrived at between the parties to the transaction, namely the trustees and the beneficiary.

Even leaving aside the fact that the transferee company shares are derived from a transaction where the beneficiary has no interest, at least directly, *qua* beneficiary, what expenditure either in money or money's worth in terms of s.38 has the beneficiary incurred? The only expenditure this writer can perceive as having been incurred is the giving up of some sort of *spes successionis* in the distributing company's shares in consideration of receiving the transferee company shares. What is the nature of this nebulous *spes*? Remember one technique suggested by Mr. McCall to defeat the problems arising from a s.213 demerger is for the trustees to sell the shares of the distributing company before the demerger to ensure all benefit arising therefrom remains capital in the hands of the trust. Such a sale presumably extinguishes this *spes* of the beneficiaries in respect of the distributing company's shares. To argue this view is correct would be to argue that this fragile *spes* was of equivalent value to the cash value of the dividend shares of the transferee company. This approach has been presented as the correct approach in print (See Robinson and Cooke "The Stock Dividend Question and Company Demergers": *Trusts and Estates* (The Magazine of Trusts and Estates Practitioners) September 1991 pp5-6). The view, in this writer's opinion barely achieves coherence, far less respectability.

It is (perhaps) interesting to recall the CCAB Press Release (1968) (Dearden Farrow; Inland Revenue Practice and Concessions FRPB/7 p.2659) which provides that on a reorganisation of share capital when a share issue is treated as income, the net amount of the dividend is allowed as the base cost of a bonus issue of such shares. This Press Release may serve to persuade the Revenue that it would be arbitrary and inconsistent to allow a base cost for income shares forming a bonus issue (albeit arguably on a concessionary basis) but to seek to deny a base cost for an income shares dividend on a s.213 demerger, whatever the technical position might be. This writer suspects that the hope is a forlorn one, however.

It is hoped that these comments are helpful. The examination of Mr. McCall of the question of whether a s.213 demerger is an exception to the *Hill* principle and his suggestions as to how to circumvent the problems arising for interest in possession beneficiaries before the demerger is effected are eminently sensible. However, even if the *Hill* principle applies to s.213 demergers, for those beneficiaries faced with a *fait accompli*, it appears that their CGT position is not as exposed as the Revenue may suggest.