Executive summary

On 26 May 2016, HM Treasury published its much awaited consultation on the potential reform of the substantial shareholdings exemption (SSE).

In the consultation, the UK Government states that it believes the SSE is generally realizing its original policy objective of ensuring that the tax treatment of share disposal gains does not discourage trading groups from restructuring or making disposals, but recognizes there have been fundamental changes domestically and internationally which raise questions around the relevance of the original policy intention and the impact it is having on the UK’s competitiveness as a holding company location.

As a result the Government is considering the possible case for reforming the current SSE regime. In this regard the consultation document proposes a number of possibilities for reform, including:

> A comprehensive exemption
> The removal of the investor trading test
> The removal of the investor trading test plus expansion of investee trading test
> The expansion of both investor and investee trading tests
> A reduction in the substantial shareholding requirement
The consultation also considers the possibility of targeted reform for the funds sector.

The consultation stresses, though, that the Government is looking for evidence to support a case for reform of the current regime, including a demonstration of the economic benefits that may arise from such a change.

The consultation also considers a number of specific points relating to the current regime (for instance the impact of partnerships and entities without share capital on SSE groups) on which it is seeking views.

Detailed discussion

On 26 May 2016, HM Treasury published a consultation on the potential reform of the SSE.

This potential reform was promised as one of the measures in the Business Tax Roadmap published in Budget 2016 to determine “...the extent to which the SSE is still delivering on its original policy objective and whether there could be changes to its detailed design in order to increase its simplicity, coherence and international competitiveness.”

The original announcement in the Roadmap was not unexpected as we have been involved in discussions with the Government for some time on the case for reforming the SSE in order to create a more attractive overall UK holding company regime, especially for real estate investors or investors in multiple asset classes.

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Current SSE regime

The current SSE regime provides for an exemption from corporation tax on chargeable gains arising on the disposal of shareholdings of 10% or more in certain companies or groups. To be eligible for the exemption the shareholding has to have been owned for at least a year, and both the investee companies being disposed of, and the investor company/group, have to be carrying on trading activities throughout that period and immediately after the disposal.

Non-trading activities (such as real estate investment, or treasury activities outside the banking sector) are only allowed to the extent they are not "substantial."

These requirements, as well as limiting the benefits of the regime, introduce a significant level of complexity in determining whether SSE is available in a particular situation.

Drivers for change

The consultation identifies the following factors as the main drivers behind a possible change in the SSE regime:

Simplicity
The relative complexity of the SSE provisions create administrative burdens and can deter groups from locating holding companies in the UK.

Competitiveness
Despite a number of features of the UK’s corporate tax regime that make it attractive as a headquarters location (e.g., the withholding tax and corporation tax exemption for dividends, an extensive treaty network, a broadly territorial regime for taxing UK company profits), the Government is aware of concerns that the current SSE regime is impacting on the UK’s attractiveness, particularly due to the unavailability of the SSE in the following situations:

• Groups with substantial investment assets
• Disposals of non-trading companies
• Disposals of investments of less than 10%
• Disposals by certain funds

Coherence
A partial capital gains exemption is arguably inconsistent with a tax regime allowing territorial tax and a comprehensive dividend exemption

Base Erosion and Profit Shifting (BEPS)
A reform of SSE could attract further investment from groups looking to consolidate existing UK management functions in line with the Organisation for Economic Co-operation and Development’s BEPS recommendations on aligning taxable income and underlying activities, whereas the current SSE regime may create a risk that groups may instead relocate existing UK management functions to countries where their holding structures are based.
Possible options for reform

With those drivers in mind, the consultation puts forward a number of possible options for reform (which it stresses are not mutually exclusive).

Option 1: comprehensive exemption
The Government is “willing to explore the case” for a comprehensive exemption for gains on share disposals in order to remain competitive with countries that offer a wider exemption. It is, however, concerned as to the tax avoidance possibilities that such a broad exemption might bring (e.g., by enveloping passive assets) and will need to be convinced that such risks are immaterial or can be protected against through anti-avoidance provisions.

Option 2: removing the investor trading test but retaining the investee trading test
This would represent a significant simplification and allow disposals to qualify where the investor group has significant non-trading assets.

Option 3: removing the investor trading test and expanding the investee test beyond trading
The Government recognizes that option 2 would still result in situations where gains on substantial disposals remain taxable so is also exploring a number of possibilities of expanding the investee test to cover, for instance:

- “Active business activities” (though this is not defined)
- Where the investee carries on a “business” (which may accommodate investment companies to the extent there are significant associated management functions), or
- Activities that would be positively defined in legislation

Option 4: amending both investor and investee trading tests
The Government considers that any of the first three options would represent fundamental changes that would require material benefits to be demonstrated before they could be considered. It is therefore also considering smaller scale changes, such as:

- Applying the trading tests just to the companies involved in the transaction rather than at group/sub-group level
- Expanding the qualifying activities within both the investor and investee tests in the way proposed in option 3. This could be achieved, for instance, by amending the non-qualifying activity test to only encompass activities which are both non-trading and passive (or fall outside a specified definition).

Option 5: reducing the substantial shareholding requirement
The Government is considering lowering the 10% threshold or augmenting it with a minimum invested capital requirement. It is, however, “generally skeptical” about the merits of such a move and so is looking for evidence of situations where disposals of large, long term shareholdings have not satisfied the current definition to determine whether there is a strong justification for this, e.g., an infrastructure project where a shareholding of less than 10% may still represent “multiple billions” of invested capital.

Funds
In addition to the general options for reform, the consultation document also specifically considers the position of funds. While pension funds and sovereign wealth funds are generally outside the scope of UK corporation tax, they may establish companies in the UK as part of their investment structure. Such funds often carry on a substantial level of non-trading activities which can be problematic in claiming the SSE on a trading company disposal.

The Government wishes to consider whether there is a case for SSE reform that is targeted towards the funds sector, given that funds that meet certain characteristics (e.g., widely owned, regulated and subject to minimum distribution requirements) represent a reduced avoidance risk.

It therefore seeks views on this, and the criteria that could be used to define qualifying funds if such an approach were taken.

Other areas
In addition to the more fundamental reform possibilities, the consultation also takes the opportunity to address a number of specific points relating to the current regime, including:

- The impact of partnerships and entities without share capital on an SSE group
- A possible extension of the period over which the 10% substantial shareholding requirement can be satisfied from two to six years to allow more time for piecemeal share disposals
- Issues relating to the post-sale investor trading requirement (which can create practical problems where, for example, a group is selling its last trading subsidiary).
Responses required

The consultation asks a number of specific questions, with responses having to be submitted by 18 August 2016. However, as an overarching point the Government is looking for evidence that would support a case for SSE reform.

In particular it is looking for examples of situations where the SSE has not been available, and invites respondents to explain how such a situation would have been dealt with under equivalent overseas exemptions and the impact this might have on the motivation for groups to locate holding companies in the UK. Furthermore, it encourages respondents to outline the associated economic benefits in bringing holding companies into the UK as a result of a reform, for instance in the form of additional employment, investment and tax receipts.

This ability to demonstrate the economic benefit of a reformed SSE is likely to be a crucial aspect in this consultation.

Endnote

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