

**EXPLANATORY MEMORANDUM TO
THE CORPORATION TAX (IMPLEMENTATION OF THE MERGERS
DIRECTIVE) REGULATIONS 2009**

2009 No. 2797

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. **Purpose of the instrument**

- 2.1 This instrument amends section 213(4) of the Income and Corporation Taxes Act 1988 (c.1) (exempt distributions) (ICTA) to extend, in relation to certain distributions on demerger, the same treatment to distributions involving member State companies as that afforded to distributions involving UK companies.
- 2.2 The amendment is made in order to ensure the UK is fully compliant with its obligations under Directive 90/434/EEC of the European Parliament and of the Council of 26 October 2005 on cross border mergers of limited liability companies (OJ 58, 4.3.2005 p. 19), as amended by Council Directive 2005/19/EC of 17 February 2005 amending Directive 90/434/EEC 1990 on the common system of taxation applicable to mergers, divisions, transfer of assets and exchanges of shares concerning companies of different member States (OJ L 310, 25.11.2005. p1) ("the Mergers Directive").

3. **Matters of special interest to the Joint Committee on Statutory Instruments**

- 3.1 The instrument is being made under section 2(2) of the European Communities Act 1972. It removes a tax charge, therefore it does not contravene the restriction in Schedule 2 to that Act, which prohibits statutory instruments made under section 2(2) from imposing or increasing taxation.

- 3.2 The instrument is being made under section 2(2) of the European Communities Act 1972 rather than under section 110 Finance Act 2007 (FA 2007) which provides the primary vires for implementation of the Mergers Directive. The reason for this is that the section 110 FA 2007 power is not considered sufficiently wide to cover the case where a distribution takes the form of a transfer of shares by a company to members who are not companies. Such a distribution falls within section 213(3)(a) ICTA and so is an exempt distribution if various conditions, including the condition in section 213(4), are met in respect of it. But the power under section 110(1)(c) FA 2007 only enables provision to be made about the tax consequence of a transfer *between companies*. Accordingly, it is not thought that the power under section 110 FA 2007 can be used to amend section 213(4) ICTA in its application to

section 213(3)(a), so far as relating to a transfer of shares to members who are individuals.

3.3 The other cases presently provided for in section 213 ICTA for UK only companies and now requiring equal treatment for other member States (pursuant to Mergers Directive and Treaty obligations) could be provided for using the section 110 FA 2007 power. However that power requires a House of Commons only procedure which cannot properly be combined with a Parliament instrument. Two separate instruments would make the legislation unnecessarily complex, so on balance it was considered more appropriate to rely solely on section 2(2) of the European Communities Act 1972 in this case.

4. Legislative Context

- 4.1 On a purposive construction of the Mergers Directive, distributions by member State companies pursuant to a share exchange (section 213(3)(b)(ii) ICTA) and those forming part of a transfer of shares (section 213(3)(a) ICTA) would need to have exempt treatment where we have provided exempt treatment for cases involving UK companies. Share exchange and transfer of shares are both ways of demerging groups of companies (“partial divisions” in the language of the Directive).
- 4.2 The transactions we are concerned with are: (1) where Co A transfers shares in its 75% subsidiary (B), to Co C who in return issues shares in C to the members of A (section 213(3)(b)(ii) ICTA); and (2) where Co A transfers, to its members, shares in its 75% subsidiary (B) (section 213(3)(a) ICTA).
- 4.3 Article 2(ba) of the Mergers Directive provides for a transfer of a branch of activity to one or more existing or new companies (a “partial division”). This is widely drawn and, particularly given a purposive construction, “assets” in the definition of “branch of activity” could include shares in a subsidiary for these purposes. The thrust of the Mergers Directive is to provide tax neutrality for reorganisations. In the case of section 213 ICTA, a UK-UK exemption exists and the Directive construed in accordance with Articles 56 (free movement of capital) and 43 (freedom of establishment) of the Treaty will require the UK to provide equal treatment to other member States.
- 4.4 The amendment made by this instrument substitutes “a member State” for “the United Kingdom”, so that the UK legislation will be fully in compliance with the obligations arising under the Mergers Directive as so construed.
- 4.5 As mentioned in more detail above (para 3.1 -3.3), the instrument is being made under section 2(2) of the European Communities Act 1972 rather than under section 110 FA 2007 (which provides the primary vires for implementation of the Mergers Directive) because that power cannot cover all the circumstances of the transactions concerned.

5. Territorial Extent and Application

5. This instrument extends to the United Kingdom and applies in relation to relevant companies in member States.

6. European Convention on Human Rights

The Financial Secretary to the Treasury, Stephen Timms has made the following statement regarding Human Rights:

In my view the provisions of the Corporation Tax (Implementation of the Mergers Directive) Regulations 2009 are compatible with the Convention rights.

7. Policy background

- *What is being done and why*

7.1 S.213 provides for distributions arising from certain demergers to be treated as ‘exempt distributions’. However s.213(4) restricts this treatment to situations where all the companies involved in the demerger are UK resident and it is from this aspect of the legislation that the Directive incompatibility arises. Demergers legislation was introduced in FA 1980 to facilitate the division of trading activities of a company or group of companies such that those activities might be carried on by two or more companies or groups of companies with similar shareholders to those of the original company or group.

7.2 The transactions facilitated would normally generate a distribution within the terms of s.209 but s.213 provides for that distribution to be an “exempt distribution” in three sets of circumstances:

- The distributing company transfers to its members shares in one or more companies that are its 75% subsidiaries. (A direct demerger). (S.213(3)(a)).
- The distributing company transfers a trade to a transferee company and the transferee company issues shares to the members of the distributing company. (An indirect demerger). (S.213 (3)(b)(i)).
- The distributing company transfers shares in a company that is its 75% subsidiary to a transferee company and the transferee company issues shares to the members of the distributing company. (An indirect demerger). (S.213(3)(b)(ii)).

7.3 S.213(4) requires that all relevant companies must be resident in the United Kingdom at the time of the distribution.

7.4 The effect of s.213 is to exempt distributions to which it applies for the purposes of the Corporation Tax Acts. Income Tax enactments relating to the taxation of company distributions fall within the definition of “the Corporation Tax Acts” (Schedule 1 to the Interpretation Act 1978 (c. 30)). Consequently, where the recipient is an individual, no charge to tax is due under Part 4 Chapter 3 ITTOIA 2005 and there is no entitlement to a tax credit.

7.5 S.213A provides exempt distribution treatment for distributions arising as a result of “partial divisions” as described by the Mergers Directive. A ‘partial division’, in broad terms, is the transfer of part of a business by one company to another in return for the shareholders of the transferring company receiving shares in the acquiring company. This is similar to an ‘indirect demerger’ falling within s.213(3)(b)(i). However, whereas s.213A applies to relevant member State companies s.213 (because of subsection (4)) only applies if each “relevant company” (as defined in s.218(1)) is UK resident.

7.6 Following advice given in the context of section 213 and 213A ICTA being re-written as part of the Tax Law Rewrite project, HMT are now no longer satisfied that section 213A ICTA (providing equal treatment in cases similar to those within s.213(3)(b)(i)) is sufficient to implement the Mergers Directive. In order to be fully compliant, we wish to provide equal treatment for UK and other member State companies, for all section s.213(3) transactions by making this amendment.

- ***Consolidation***

7.7 Sections 213 and 213A ICTA will be re-written as part of the Corporation Tax Bill, which the tax law re-write project is proposing to introduce at the start of the 2009-2010 session of Parliament.

8. Consultation outcome

8.1 No consultation has been undertaken.

9. Guidance

9.1 These Regulations do not impose any new obligations.

10. Impact

10.1 No impact on business, charities or voluntary bodies is foreseen.

10.2 No impact on the public sector is foreseen.

10.3 An Impact Assessment has not been prepared for this instrument as no impact for business, charities, voluntary bodies or public sector is foreseen.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 These Regulations will not be subject to specific monitoring or review.

13. Contact

Simon Moulden at HMRC Tel: 0207 147 2629 or email:
simon.moulden@hmrc.gsi.gov.uk can answer any queries regarding the
instrument.

<p>Article 8 1.</p>	<p>Tax treatment of allotment of shares on</p> <ol style="list-style-type: none"> 1. Merger 2. Transfer of Assets 	<ol style="list-style-type: none"> 1. Merger <ul style="list-style-type: none"> • S140G TCGA 1992 2. Transfer of Assets <ul style="list-style-type: none"> • S140DA TCGA 1992 • S12G Sch 9 FA 1996
<p>2.</p>	<p>Tax treatment of allotment of shares on partial division</p>	<ul style="list-style-type: none"> • S. 140DA TCGA 1992 • S213A and S 218 ICTA 1988 • Para 12G Sch 9 FA 1996 <p>Definitions: S140L TCGA 1992</p>
<p>3</p>	<p>Tax treatment of allotment of shares when entity treated as fiscally transparent.</p>	<ul style="list-style-type: none"> • S 140I TCGA 1992 • S 140J TCGA 1992 • Para 12H Sch 9 FA 1996
<p>Article 10 1.</p>	<p>Renunciation of taxing rights where assets transferred include a permanent establishment in another member state.</p>	<ol style="list-style-type: none"> 1. Mergers <ul style="list-style-type: none"> • S140F TCGA 1992 • Para 87A Sch 29 FA 2002 • Para 12C Sch 9 FA 1996 • Para 30C Sch 26 FA 2002 2. Transfer of Assets <ul style="list-style-type: none"> • S 140C TCGA 1992 • Para 87 Sch 29 FA 2002 • Para 12E Sch 9 FA 1996 • Para 30E Sch 26 FA 2002 3. Partial Divisions <ul style="list-style-type: none"> • S 140C TCGA 1992 • Held over gains: S140(6AA) , S154 (2D) , S179 (1AA) TCGA 1992 • Para 87 Sch 29 FA 2002 • Para 12E Sch 9 FA 1996 • Para 30E Sch 26 FA 2002 4. Definitions S140L TCGA 1992
<p>Article 10a</p>	<p>Special case of transparent entities. Exercise of right to disapply provisions.</p>	<ol style="list-style-type: none"> 1. Share Exchange <ul style="list-style-type: none"> • S 140H TCGA 1992 2. Mergers <ul style="list-style-type: none"> • S 140J TCGA 1992 • Para 12I Sch 9 FA 1996 • Para 30H Sch 26 FA 2002 • Para 85C Sch 29 FA 2002 3. Transfer of Assets <ul style="list-style-type: none"> • S 140I TCGA 1992 • Para 12H Sch 9 FA 1996 • Para 30G Sch 26 FA 2002 • Para 85B Sch 29 FA 2002 4. Partial Divisions <ul style="list-style-type: none"> • S 140I TCGA 1992 • Para 12H Sch 9 FA 1996 • Para 30G Sch 26 FA 2002 • Para 85B Sch 29 FA 2002

		<p>5. Double taxation provisions</p> <ul style="list-style-type: none"> • S 140K TCGA 1992 <p>6. Definitions</p> <ul style="list-style-type: none"> • S140L TCGA 1992 • Para 12J Sch 9 FA 1996 • Para 30I Sch 26 FA 2002 • Para 85D Sch 29 FA 2002
Article 10b,c and d	Transfer of registered office of SE and SCE	S66A FA 1988
Article 11 (1)	Anti Avoidance measures	<ul style="list-style-type: none"> • S 140B TCGA 1992 • S140D TCGA 1992 • Para 12B(6) Sch 9 FA 1996 • Para 12F Sch 9 FA 1996 • Para 30B (6) Sch 26 FA 1996 • Para 30F Sch 26 FA 2002 • S 85 Sch 29 FA 2002 • S 87 Sch 29 FA 2002